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## Audits of state and local governmental units with conforming changes as of May 1, 1998; Audit and accounting guide:

American Institute of Certified Public Accountants. Government Accounting and Auditing Committee

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**AICPA  
AUDIT AND  
ACCOUNTING  
GUIDE**

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# **AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS**

***With Conforming Changes as of  
May 1, 1996***



American Institute of  
Certified Public Accountants

# ***AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS***

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May 1, 1996***

This edition of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, which was originally issued in 1994, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued. The changes made are identified in a schedule in appendix L of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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## NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Government Accounting and Auditing Committee on the application of generally accepted auditing standards to audits of financial statements of state and local governmental units. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for state and local governmental units. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

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## Preface

This guide supersedes the 1986 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that guide with conforming changes made by the AICPA staff. It has been prepared to assist the independent auditor in auditing the financial statements of governmental units other than the federal government. Part VII, "Audits of Federal Financial Assistance," provides guidance to independent auditors planning or conducting audits involving federal financial assistance under the requirements of the Single Audit Act of 1984. The guide is intended to be an initial reference source for the independent auditor who is new to governmental accounting and auditing. It assumes that the reader has expertise in accounting and auditing generally, but not in the specialized accounting or auditing practices applicable to state or local governmental units. Accordingly, the discussion of audit procedures concentrates primarily on those unique to governmental audits. The nature, timing, and extent of such auditing procedures are a matter of professional judgment and will vary depending upon the size, organizational structure, existing internal control structure, and other factors in a particular engagement. The guide includes audit guidance through the AICPA's Statement on Auditing Standards (SAS) No. 77, *Amendments to SAS No. 22, Planning and Supervision, No. 59, The Auditor's Ability to Continue as a Going Concern, and SAS No. 62, Special Reports* (AICPA, *Professional Standards*, vol. 1, AU secs. 311, 341, and 623). It also includes guidance on SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). It does not include revisions related to SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), which is effective for audits of financial statements for periods beginning on or after January 1, 1997.

The intent of the guide is to discuss accounting pronouncements and recognized practices unique to governmental units. It contains accounting guidance, some of which was in the 1986 Audit and Accounting Guide *Audits of State and Local Governmental Units* but not addressed in Governmental Accounting Standards Board (GASB) pronouncements, and some of which is new guidance. The guidance provided on issues not addressed in GASB pronouncements, however, is *neutral*—that is, the alternative accounting and reporting possibilities are presented, but without recommendations for one alternative over another. Readers should review the annually updated Audit Risk Alert, *State and Local Governmental Developments*, a publication in the AICPA series that identifies and discusses audit and accounting developments. Paragraphs 12 and 13 of SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411.12 and .13), address the application to state and local governmental entities of established accounting principles that are generally accepted in the United States. The GASB's *Codification of Governmental Accounting and Financial Reporting Standards* and any GASB Statements issued after its publication date contain the governmental accounting and reporting standards. This guide includes accounting and reporting guidance through GASB Statement No. 30, *Risk Financing Omnibus*, and GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*. The effective dates of this guidance should be applied as provided for in the related literature.

The guide supersedes AICPA Statement of Position (SOP) 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance*. The information from SOP 92-7 is incorporated into the following:

- Chapter 5, "Testing and Reporting on Compliance With Laws and Regulations"
- Part VII, "Audits of Federal Financial Assistance," which includes chapters 20, "Introduction to the Single Audit," 21, "Single Audit Planning," 22, "Supplementary Schedule of Federal Financial Assistance," 23, "Performing the Audit of Federal Financial Assistance Programs," and 24, "Reporting Under the Single Audit Act and OMB Circular A-128"
- Appendix A, "Illustrative Auditor's Reports"
- Appendix D, "Questions and Answers on the Single Audit Process of OMB Circular A-128"
- Appendix F, "The Common Rule—Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments"
- Appendix G, "Key Events in the History of Auditing Federal Programs"
- Appendix H, "Single Audit Literature"
- Appendix I, "Federal Quality Control Procedures"

Chapter 18, "Auditor's Reports on Basic or General-Purpose Financial Statements," also includes final guidance from the related February 1993 SOP Exposure Draft, *Reporting on Separately Issued Summary Financial Information Prepared by State or Local Governmental Units*.

This guide includes the provisions of the 1994 revision to *Government Auditing Standards* issued by the U.S. General Accounting Office (GAO). In July 1996, legislation was passed amending the Single Audit Act of 1984. The new law (Public Law 104-156) makes several important changes to the Act including, among other provisions, an increase in the audit threshold to \$300,000, the implementation of a risk-based audit approach, and the extension of the Act's jurisdiction to not-for-profit organizations. The Single Audit Act Amendments of 1996 are effective for fiscal years beginning after June 30, 1996. At the same time, the U.S. Office of Management and Budget (OMB) is moving forward on a project to combine the audit requirements under OMB Circular A-128, *Audits of State and Local Governments*, and A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. As the first step in this project, the OMB issued revisions to OMB Circular A-133 in April 1996. It is expected that the OMB will publish a notice in the *Federal Register* during the third quarter of 1996 to rescind OMB Circular A-128 and further revise OMB Circular A-133 to be applicable to audits of state and local governments, colleges and universities, and not-for-profit organizations. This guide does not include the new audit requirements for audits of federal financial assistance. The AICPA is in the process of developing revised audit guidance to address the new requirements. Readers should be alert for revised AICPA guidance that would amend this guide accordingly.

The auditing guidance in the guide is effective for audits of financial statements for fiscal periods ending after September 15, 1994. This printing of the guide includes conforming changes as of May 1, 1996. These conforming changes are effective as of the effective date of the pronouncements to which they relate.

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# Part I

## Introduction

# Chapter 1

## Overview

### Introduction

**1.01** Governmental accounting and auditing is unique in many respects. Its multifund structure, extensive reporting requirements, basis of accounting, and budgetary and other legal compliance requirements present an environment that is significantly different from that encountered in the audit of a commercial or not-for-profit organization. An audit of a governmental unit may be conducted under three different *levels* of audit standards or requirements: generally accepted auditing standards (GAAS), *Government Auditing Standards* (often called the Yellow Book, generally accepted government auditing standards, or GAGAS) issued by the Comptroller General of the United States, or the additional requirements of the Single Audit Act of 1984 (the Single Audit Act). The different requirements encompassed by each *level* of auditing standards are discussed in this guide. The auditor, before accepting an engagement, should understand which auditing standards or requirements apply to the engagement.

**1.02** AICPA Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), states that, if, during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements. See chapter 5, “Testing and Reporting on Compliance With Laws and Regulations,” paragraphs 5.03 through 5.05, for a discussion of the requirements of SAS No. 74 relating to the auditor’s responsibilities in this situation.

**1.03** There are over 86,000<sup>1</sup> state and local governmental units in the United States. These include the following:

- States
- Counties
- Cities, towns, and villages
- School districts
- Municipal utility districts
- Public benefit corporations and authorities
- Public employee retirement systems (PERS)
- Governmental colleges and universities
- Governmental hospitals and other providers of health care services
- Other special purpose districts and authorities, established to provide services such as sanitation, or to manage enterprises such as toll roads and airports

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<sup>1</sup> U.S. Bureau of the Census, *Census of Governments, 1987 and 1992*, vol. 1, no. 1, Government Organization.

## The Role of This Guide

**1.04** The purpose of this guide is to provide guidance for accounting, auditing, and reporting on the financial statements of state and local governmental entities. The guide is based on existing pronouncements of authoritative standard-setting boards as well as other sources of generally accepted accounting principles (GAAP). It does not establish new accounting principles or auditing standards, or modify existing ones. Hence, its guidance may have been superseded by standards or regulations issued since its publication. Therefore, when planning and conducting an audit engagement, the auditor should refer to the most recent pronouncements of the Governmental Accounting Standards Board (GASB), the Auditing Standards Board and the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA), the Comptroller General of the United States, the U.S. General Accounting Office (GAO), the U.S. Office of Management and Budget (OMB), and pertinent government agencies.

**1.05** This guide should be followed when the auditor is engaged to audit a governmental college or university that has elected to account for its activities using the “governmental model.” An auditor engaged to audit a governmental college or university that has elected to account for its activities using the “AICPA college guide model” should also refer to the guidance in the AICPA Industry Audit Guide *Audits of Colleges and Universities*. (Auditors should note that although *Audits of Colleges and Universities* has been superseded by the recently issued Audit and Accounting Guide *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment.) These alternative models are recognized in the *Codification of Governmental Accounting and Financial Reporting Standards* (GASB Codification), Section Co5 (GASB Cod. sec. Co5), which states that governmental colleges and universities should use one of the following two accounting and financial reporting models:

- a. **The AICPA college guide model.** The accounting and financial reporting guidance recognized by the AICPA Industry Audit Guide *Audits of Colleges and Universities* as amended by AICPA Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable Financial Accounting Standards Board (FASB) pronouncements issued through November 30, 1989, and by all applicable GASB pronouncements.
- b. **The governmental model.** The accounting and financial reporting standards established by the National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, as modified by subsequent NCGA and GASB pronouncements.

**1.06** If the auditor is engaged to audit the separate financial statements of a governmental health care entity (that is, a governmental hospital or other provider of health care services) that uses enterprise fund accounting and reporting, the auditor should refer to the AICPA Audit and Accounting Guide *Health Care Organizations*, GASB literature, and, if applicable, AICPA SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*. Chapters 3, “Planning the Audit,” and 15, “Special Governmental Units,” provide further guidance.

**1.07** If the auditor is engaged to audit a PERS, the auditor should refer to the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for audit guidance.

**1.08** If the auditor is engaged to audit the separate financial statements of a governmental entity that heretofore has applied not-for-profit accounting and financial reporting principles, the auditor should refer to GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*. GASB Statement No. 29 provides that these entities should account for their activities using either the “governmental model” or the “AICPA not-for-profit model.” The following describes each alternative model:

- a. *The AICPA not-for-profit model.*** The accounting and financial reporting principles contained in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*—except for the provisions relating to the joint costs of informational materials and activities that include a fund-raising appeal—as modified by all applicable FASB pronouncements issued through November 30, 1989, and as modified by most applicable GASB pronouncements. (Auditors should note that although SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations* have been superseded by the recently issued Audit and Accounting Guide *Not-for-Profit Organizations*, they continue to be applicable in a governmental environment.)
- b. *The governmental model.*** The accounting and financial reporting standards established by the NCGA Statement 1, as modified by subsequent NCGA and GASB pronouncements. An auditor engaged to audit a governmental entity that has elected to account for its activities using the governmental model should refer to this guide for audit guidance.

**1.09** The guidance presented here is not all-inclusive; rather, it is limited to matters that warrant special emphasis or that experience has indicated may be useful. This guide is based on the assumption that its users are, for the most part, knowledgeable in accounting and auditing, so it focuses on specific areas of auditing, accounting, and reporting with respect to the financial statements of state and local governments. Accordingly, the guide does not discuss the application of all GAAP and GAAS as they pertain to the audit of such financial statements. The nature, timing, and extent of auditing procedures are matters of professional judgment and will vary according to the size of the entity, the operations and administrative structure, the auditor’s assessment of the level of risk, and other factors. The independent auditor is also expected to be familiar with applicable governmental laws and regulations.

## Background

**1.10 *Accounting Principles.*** In 1968, NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles* was published. At its time of publication, this source was recognized widely as an authoritative reference for GAAP for state and local governmental units. However, it is no longer authoritative.

**1.11** In 1979, the NCGA issued the first of its seven statements and eleven interpretations providing additional guidance on governmental accounting and reporting matters, and, subsequently, issued additional statements and interpretations expanding on the basic principles established in its

first statement. Although the NCGA was not recognized by the AICPA as a standard-setting body (and, therefore, not officially recognized as a source of GAAP for government), NCGA statements and interpretations were widely followed and generally accepted by preparers of and attestors to the financial statements of state and local governments.

1.12 In 1984, the Financial Accounting Foundation (FAF) created the Governmental Accounting Standards Board. The GASB is recognized as the standard-setting authority of GAAP for state and local units of government, as discussed in paragraphs 1.17 through 1.19. (GASB Statement No. 1, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*, paragraph 8, addresses the authoritative status of NCGA Statements and Interpretations.) The FASB and the GASB have agreed on the definition of a *governmental organization*. This agreement was reached in a public meeting in which the FASB and the GASB cleared the proposed Audit and Accounting Guide *Health Care Organizations* for final issuance. Therefore, the following definition of a governmental organization should be considered by auditors in determining whether an entity is applying the appropriate GAAP:

Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
- The potential for unilateral dissolution by a government with the net assets reverting to a government; or
- The power to enact *and* enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

1.13 **Auditing Standards.** In addition to GAAS established by the AICPA, auditors of state and local governmental units may also need to comply with *Government Auditing Standards*. Certain aspects of GAAS and *Government Auditing Standards* establish auditing and reporting requirements for state and local governmental units that extend beyond those required in a financial audit of most for-profit organizations.

1.14 When auditing a governmental unit, the auditor may be required to comply with the audit requirements of the Single Audit Act of 1984. The Single Audit Act, which establishes audit requirements for state and local governments receiving federal financial assistance, imposes auditing and reporting requirements beyond those required by GAAS and *Government Auditing Standards*. Audits conducted under the requirements of the Single Audit Act are referred to as *single audits*. The Single Audit Act is included in appendix C.

1.15 Auditing in the state and local governmental arena includes several other unique aspects. Governmental organizations, by their nature, manage public funds, rather than those of an individual, a closely held group, or a voluntary investment in a venture. Therefore, there is, perhaps, more public in-

terest in the accountability for those funds. There may be qualitative issues, such as controversial new revenue sources or projects, or job performance issues, that an auditor may need to address but that may not be part of an audit of the financial statements of non-governmental organizations. Additionally, public funds are required to be administered in accordance with laws and regulations for which noncompliance could have a material effect on the government's financial statements. Because of these unique aspects, *Government Auditing Standards* notes that auditors may set lower materiality levels in an audit of the financial statements of a government entity or an entity that receives government assistance than in audits in the private sector.

## Organization of This Guide

1.16 This guide is organized as follows:

- Part I, "Introduction," discusses the financial reporting entity and fund structure. This discussion takes into consideration the fact that governmental units become involved in a variety of ventures, which may or may not be part of the audited entity. It also provides guidance on planning the audit, the auditor's understanding of the entity's internal control structure, and compliance testing.
- Part II, "The State and Local Government Audit—Governmental Funds and Account Groups," addresses the budget, cash and investments, receivables and revenues, expenditures and related liabilities, capital expenditures and related fund and account group activity, debt and debt service, and interfund transactions and fund equity.
- Part III, "The State and Local Government Audit—Proprietary and Fiduciary Funds," addresses enterprise funds, internal service funds, expendable trust funds, nonexpendable trust funds, pension trust funds and agency funds.
- Part IV, "Other Governmental Audit Engagements," highlights special governmental units and state governments.
- Part V, "Concluding the Audit," discusses representations from management, related party transactions, going concern considerations, commitments and contingencies, subsequent events, and analytical procedures.
- Part VI, "Auditor's Reports," discusses auditor's reports on basic or general-purpose financial statements (GPFS) and association with financial statements included in official statements.
- Part VII, "Audits of Federal Financial Assistance," discusses audits of federal financial assistance in accordance with the Single Audit Act of 1984.

## Generally Accepted Accounting Principles for State and Local Governments

1.17 The sources of established accounting principles that are generally accepted in the United States are—

- a. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to Rule 203 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 203.01). Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements

contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 states that the application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with GAAP. Nevertheless, Rule 203 provides for the possibility that the literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See paragraphs 14 and 15 of SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508.14 and .15].)

- b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category *a* (see paragraph 1.18). The word *cleared* means that a body referred to in subparagraph *a* has indicated that it does not object to the issuance of the proposed pronouncement.
- c. Pronouncements of bodies, organized by a body referred to in category *a* and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category *b* (see paragraph 1.18) that have been cleared by a body referred to in category *a* but have not been exposed for public comment.
- d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

**1.18** The GASB is the recognized standard-setting authority of GAAP for state and local governments. However, in the absence of a relevant pronouncement by the GASB, auditors may look to other sources for authoritative guidance. In 1991, the AICPA issued SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), which adopted a hierarchy of GAAP applicable to state and local governmental entities, indicating the level of authority of various sources. The application of GAAP for financial statements of state and local governmental entities is as follows:

- a. Category *a*, officially established accounting principles, consists of GASB Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations. GASB Statements and Interpretations are periodically incorporated in the GASB Codification.
- b. Category *b* consists of GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA

and cleared<sup>2</sup> by the GASB, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position.

- c. Category *c* consists of the AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins, if specifically made applicable to state and local governmental entities and cleared by the GASB, as well as consensus positions of a group of accountants organized by the GASB that attempt to reach consensus positions on accounting issues applicable to state and local governmental entities.<sup>3</sup>
- d. Category *d* includes implementation guides (*Qs and As*) published by the GASB staff, as well as practices that are widely recognized and prevalent in state and local government.

**1.19** In the absence of a pronouncement covered by Rule 203 or another source of established accounting principles, the auditor of financial statements of state and local governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, GASB Concepts Statements; the pronouncements referred to in categories *a* through *d* of SAS No. 69, paragraph 10 (AICPA, *Professional Standards*, vol. 1, AU sec. 411.10) (consisting principally of FASB Statements and Interpretations), when not specifically made applicable to state and local governmental entities either by the GASB or by the organization issuing them; Accounting Principles Board (APB) Statements; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, GASB Concepts Statements would normally be more influential than other sources in this category. GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, provides guidance on applying the SAS No. 69 hierarchy to governmental units that report using proprietary fund (enterprise and internal service fund) accounting and financial reporting.

## Applicable Auditing Standards

**1.20** Audits of financial statements of state and local governments should satisfy applicable auditing standards established by the AICPA, which are usually referred to as GAAS. These auditing standards have been issued as Statements on Auditing Standards, Statements of Position, and Auditing Interpretations. SAS No. 74 is particularly relevant to auditors of state and local governments.<sup>[4]</sup> (Auditors may also be engaged to provide attest services, for example, an engagement to express a conclusion about the reliability of a written assertion that is the responsibility of another party. Those engagements are conducted in accordance with the Attestation Standards, which are not within the scope of this guide.)

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<sup>2</sup> The auditor should assume that such pronouncements specifically made applicable to state and local governments have been cleared by the GASB, unless the pronouncement indicates otherwise.

<sup>3</sup> As of the date of this guide, the GASB had not established such a group.

<sup>[4]</sup> [Deleted.]



**1.21** The Comptroller General of the United States has issued *Government Auditing Standards*, which is periodically revised. These standards are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. *Government Auditing Standards* includes requirements relating to the auditor's professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. The Single Audit Act stipulates that *Government Auditing Standards* be followed in all audit engagements of state and local governments conducted in accordance with the Act.

**1.22** *Government Auditing Standards* incorporates all AICPA audit standards for field work and reporting and its general standards are similar to those of the AICPA. However, *Government Auditing Standards* also contains additional general, field work, and reporting standards. Included in the general standards are additional requirements for continuing professional education and external quality control reviews. For example, auditors responsible for planning or directing an audit, conducting substantial portions of field work, or reporting on an audit under *Government Auditing Standards* are required to complete, every two years, at least eighty hours of continuing education, with at least twenty-four of those hours in subjects directly related to the government environment and government auditing. In addition, organizations conducting government audits are required to have an appropriate internal quality control system in place and undergo an external quality control review. This external quality control review should be conducted at least once every three years. The auditor, when seeking to enter into a contract to perform an audit, should provide his or her most recent external quality control report<sup>5</sup> to the party contracting for the audit. Further, *Government Auditing Standards*, chapter 3, paragraphs 3.11 through 3.25, contains additional independence requirements for both individual auditors and audit firms or organizations. Auditors should also be aware that certain federal agencies have independence requirements that exceed those in *Government Auditing Standards*.

**1.23** *Government Auditing Standards* addresses two types of audits: financial and performance. Financial audits include financial statement and financial related audits. Financial statement audits are defined as providing reasonable assurance about whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flows in conformity with GAAP. Financial statement audits also include audits of financial statements prepared in conformity with other comprehensive bases of accounting discussed in paragraphs 2 through 10 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.02 through .10). Financial related audits include providing reasonable assurance that financial information is presented in accordance with established or stated criteria, whether the entity has adhered to specific financial compliance requirements, or whether the entity's internal control structure over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives (*Government Auditing Standards*, chapter 2, paragraph 2.4). A performance audit, by contrast, is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action (*Government Auditing Standards*, chapter 2, paragraph 2.6). Perform-

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<sup>5</sup> The term "report" does not include separate letters of comment.

ance audits include economy and efficiency and program audits. This guide provides guidance on financial audits and does not address performance audits.

**1.24** The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.04), states:

If a member...undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, in addition to generally accepted auditing standards, he or she is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of Rule 501 of the AICPA Code of Professional Conduct, unless the auditor discloses in his or her report the fact that such requirements were not followed and the reason therefor.

## Additional Audit Requirements

**1.25** As previously noted, the Single Audit Act imposes additional audit responsibilities on independent auditors of state and local governments that receive federal financial assistance. OMB is the federal agency designated as having primary responsibility for implementing the Single Audit Act. OMB Circular A-128, *Audits of State and Local Governments*, sets forth audit requirements for state and local governments receiving federal assistance. A supporting OMB document, *Compliance Supplement for Single Audits of State and Local Governments*, identifies the significant compliance requirements to be considered in single audits of these governments. Single audits are discussed in part VII, "Audits of Federal Financial Assistance."

**1.26** When state and local governments have component units involved in higher education or other not-for-profit activities (and in certain circumstances hospitals), the audit of the component unit may have to be conducted under the provisions of OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. If the component unit is an educational institution included in a statewide audit, it can elect to have the audit conducted in accordance with OMB Circular A-128 in lieu of OMB Circular A-133. The Single Audit Act and OMB Circular A-128 require that federal funds redistributed (that is, "passed through") to other entities be tested on the same basis as funds received by the subrecipient directly from the federal government. If the government entity redistributes funds to a component unit to which OMB Circular A-133 would apply, the audit of the component unit would likely have to be carried out under the provisions of OMB Circular A-133. AICPA SOP 92-9 provides guidance to auditors when conducting an audit in accordance with OMB Circular A-133.

**1.27** Prior to undertaking audits of state and local governments, or of specific government grants, programs, or contracts, independent auditors should be knowledgeable of the compliance requirements and auditing standards that have an impact on the scope of the engagement, including those promulgated by the state or federal agency that has oversight authority over the government or is responsible for administering the specific grant, program, or contract.

## Other Sources of Guidance

**1.28** The following are nonauthoritative sources of guidance that may be useful in conducting audits of state and local governmental units.

- The AICPA issues an annual Audit Risk Alert *State and Local Governmental Developments*, which provides an overview of economic and industry conditions and recently issued accounting and auditing pronouncements that may affect audits of governmental units.
- The AICPA has also developed a basic audit program for audits of state and local governments. Although the program must be customized for specific engagements, it is a useful starting point for planning a government audit. It is included in a nonauthoritative practice aid, the *Local Governmental Audit and Accounting Manual*.
- The Government Finance Officers Association (GFOA) publishes *Governmental Accounting, Auditing and Financial Reporting (GAAFR)*. Revised periodically, GAAFR features comprehensive explanations of the principles and standards established by the GASB or the AICPA, examples of how to account for specific types of transactions (including journal entries), and illustrations of financial statements.

**1.29** Sources of single audit guidance are listed in appendix H, “Single Audit Literature.”

## Chapter 2

# ***The Financial Reporting Entity and Fund Structure***

### **Introduction**

**2.01** GASB Statement No. 14, *The Financial Reporting Entity* (GASB Cod. sec. 2100 and 2600), revised the standards for defining the financial reporting entity and identifying entities to be included in its GPFS. Even though standards existed before the issuance of GASB Statement No. 14, requirements were inconsistently interpreted, resulting in situations where significant activities controlled by the primary government may have been omitted from the GPFS. Thus, even though GASB Statement No. 14 provides substantial guidance concerning entities to be included in the financial reporting entity's financial statements, the financial reporting entity concept is still a relatively new and evolving area. GASB Statement No. 14 has initiated a concept of *discrete* presentation by the separation of some component units<sup>6</sup> from the primary government. In addition, there are a host of emerging issues regarding financial reporting and auditor responsibility for the discrete column information.

**2.02** GASB Cod. sec. 2100 provides guidance to determine which component units should be included in the primary government's financial statements. Requirements for inclusion have been more specifically defined based on financial accountability, as compared with previous standards based on oversight responsibility. Also, reporting certain component units discretely in the financial statements, rather than blended with the financial information of the other funds, is intended to make the financial statements of the primary government more meaningful to users.

**2.03** The purpose of this chapter is to alert auditors to the major considerations of the reporting entity definition and related reporting matters. However, auditors should refer to GASB Cod. sec. 2100 and 2600 for a complete discussion of the standards and for illustrative financial statement formats. Auditors need to address these matters during the planning, testing, and reporting phases of the audit.

**2.04** During the initial planning stages of an audit, the auditor should assess whether the governmental unit has identified all potential component units. To assist the auditor in determining that the client has identified correctly which component units should be included in the financial statements, the auditor should be familiar with the requirements and terminology in GASB Cod. sec. 2100 and 2600.

**2.05** The determination of which potential component units should be included in the financial statements is not always a simple task. In some situations, the state attorney general, state auditor, auditor general, or legal counsel may need to be consulted. If component units are excluded from the financial statements of the governmental unit, the auditor should inform the client of the effect of the omission on the auditor's report.

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<sup>6</sup> Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A component unit may be a governmental organization, a not-for-profit corporation, or a for-profit corporation.

**2.06** It is also important to determine all potential component units early during the planning phase to ensure that the audit is properly coordinated and the materiality levels appropriately established (see chapter 3, "Planning the Audit," paragraph 3.12 herein). Some component units may be audited by other auditors (see paragraph 3.10 herein). Delivery deadlines need to be established to ensure that audits of the component units are completed in time to be included in the financial statements of the primary government. Certain component units may also require special expertise, such as on health care, insurance, or actuarial matters. These specialized areas should be identified early to ensure that personnel with the required experience will be available when needed.

## Financial Reporting Entity

**2.07** The definition of the financial reporting entity is primarily based on the concept of financial accountability. Financial accountability exists if a primary government appoints a voting majority of an organization's governing body, *and is either able to impose its will on that organization or there is a potential for the organization to provide a specific financial benefit to, or impose specific financial burdens on, the primary government.* Governmental units create separate organizations for a variety of reasons. Despite the outward appearance of autonomy, or separateness, these organizations are administered customarily by governing bodies that have been appointed by the elected officials of a primary government. Thus, the elected officials are accountable to citizens for their public policy decisions, regardless of whether those decisions are carried out directly by the elected officials through the operations of the primary government or by their designees through the operations of specially created organizations. This broad-based notion of accountability by elected officials leads to the underlying concept of the governmental financial reporting entity.

## Applicability

**2.08** The requirements of GASB Cod. sec. 2100 and 2600 apply at all levels to all state and local governments and to the financial reporting of the following:

- Primary governments
- Governmental joint ventures
- Jointly governed organizations
- Other stand-alone governments

The requirements apply whether the financial statements are those of a financial reporting entity or the separately issued financial statements of governmental component units. In addition, GASB Statement No. 14 should be applied to all governmental and nongovernmental component units when they are included in a governmental financial reporting entity.

**2.09** The financial reporting entity consists of the following:

- The primary government
- Organizations for which the primary government is financially accountable
- Other organizations whose relationship with the primary government is so significant that the financial reporting entity's financial statements would be misleading or incomplete if the organization were to be excluded

**2.10** GASB Cod. sec. 2100.112 defines a primary government as any state government or general-purpose local government (for example, a municipality or county). A primary government is also a special-purpose government (for example, a school district or a park district) that meets *all* of the following criteria:

- It has a separately elected governing body
- It is legally separate
- It is fiscally independent

The primary government consists of all funds, organizations, institutions, agencies, departments, and offices that make up the legal entity. Therefore, auditors should assess whether all related financial information of the financial reporting entity is reported. GASB Cod. sec. 2100 provides guidance to assist auditors in determining separate legal standing and fiscal independence.

**2.11** Component units are legally separate organizations (to include not-for-profit or for-profit corporations) for which elected officials of the primary government are financially accountable (to include organizations that are fiscally dependent). Auditors are referred to GASB Cod. sec. 2100 for a detailed discussion of various considerations related to the foregoing criteria. GASB Cod. sec. 2100.901 provides a flowchart as an aid for evaluating potential component units of a particular reporting entity.

## Reporting

**2.12** Auditors should determine that the financial statements of the reporting entity permit the reader to clearly distinguish between the primary government and its component units. Some component units have close relationships with the primary government, and their financial statements should be blended as if they were part of the primary government; however, most component unit financial statements will be discretely presented. GASB Cod. sec. 2600 provides standards and disclosure requirements for both types of presentations.

**2.13** The auditor should also obtain assurance that the notes to the financial statements distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units. GASB Cod. sec. 2600.130-.131 and J50 discuss disclosures of the reporting entity's relationships with certain organizations other than component units, including the following:

- Related organizations
- Joint ventures
- Jointly governed organizations
- Component units and related organizations with joint venture characteristics
- Pools
- Undivided interests
- Cost-sharing arrangements

The auditor needs to review carefully disclosure requirements for these types of related organizations.

## Fund Structure

**2.14** Within a primary government, the accounting systems and financial reports of a governmental unit are organized on a fund basis. Each fund is a

separate fiscal entity in the governmental unit, much the same as various corporate subsidiaries are fiscally separate in private enterprise. The separate funds are established by the governmental entity for specific fiscal accountability in accordance with statutes, laws, regulations, restrictions, or specific purposes.

## Fund Categories

**2.15** The auditor should refer to GASB Cod. sec. 1300 for the governmental principles of fund accounting for the seven major fund types and two account group categories. The following is a brief summary of the basic overall fund structure of a governmental unit:

- Fund types are—
  - Governmental funds, which include—
    - (a) General fund.
    - (b) Special revenue funds.
    - (c) Capital projects funds.
    - (d) Debt service funds.
  - Proprietary funds, which include—
    - (a) Enterprise funds.
    - (b) Internal service funds.
  - Fiduciary funds, which include trust and agency funds.
- Account groups, which include—
  - (a) General fixed assets account group.
  - (b) General long-term debt account group.
- Component units discretely presented.

## Number of Funds

**2.16** There is no specific number of funds that should be utilized by a governmental entity. GASB Cod. sec. 1300 states only that the entity “should establish and maintain those funds required by law and sound financial administration.” However, the same section indicates that governments shall report only one general fund.

**2.17** The auditor should determine that separate funds are maintained and reported when required by law or other external restrictions. However, accounting principles do not require separate funds (unless mandated) to account for restricted resources, provided that applicable legal requirements can be appropriately satisfied (see GASB Cod. sec. 1300.107). The auditor also should recognize that those employed by the governmental entity’s funding sources will often interchange the terms *funds* and *accounts*; in most instances, the use of those terms does not necessitate a separate fund entity or bank account, as long as a separate accounting is provided for restricted resources.

## Reporting Entity Presentation

**2.18** The reporting entity principles included in GASB Cod. sec. 2600 require the preparers of financial statements to distinguish between the primary government, including its blended component units, and its discretely presented component units. These changes may affect the fund presentations in the financial statements. (Guidance on the determination of materiality is provided in paragraph 3.12 herein.) For example, special districts previously

blended and reported within the special revenue funds (and perhaps even account groups), or municipal utilities previously blended and reported as enterprise funds, may require a discrete presentation.

**2.19** GASB Cod. sec. 2100.902 through .920 and 2600.902 through .910 provide illustrative examples, disclosures, and financial statement formats that provide added guidance for the financial reporting entity and the related fund presentation.



## Chapter 3

# Planning the Audit

### Introduction

**3.01** SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), provides guidance on the considerations and procedures applicable to planning and supervision of the audit. In planning an audit of a state or local governmental unit, the auditor should—

- Identify the engagement's reporting objectives.
- Identify the auditor's role as principal auditor, component unit auditor, or joint auditor.
- Consider the audit focus of governmental financial statements and level of materiality.
- Obtain an understanding of the governmental unit.
- Obtain an understanding of the internal control structure and perform a control risk assessment.
- Evaluate factors affecting the risk of financial statement misrepresentations.
- Establish the audit approach, including the development of an audit program.
- Communicate with the client concerning engagement details and auditor/client responsibilities, including the communication required by *Government Auditing Standards* discussed further in paragraph 3.04.
- Inquire whether there is a need for any special audits or reports.
- Assess management's identification of the laws and regulations that have a direct and material effect on the determination of amounts in the financial statements.
- Perform preliminary analytical procedures.
- Consider other matters affecting the conduct of the audit, including management representation letters, lawyer letters, the applicability of other audit and accounting guides, component unit disclosure issues, unresolved accounting and auditing issues, and auditor independence.

Planning the audit is required by GAAS, and the process continues throughout the audit. Early planning is useful in establishing the probable level and type of effort necessary to conduct the engagement.

**3.02** The auditor should make sure that the client understands clearly the purpose, terms, nature, and limitations of the engagement. The reporting objectives and other responsibilities assumed by the auditor should be communicated clearly to the client. The responsibilities accepted by the client, such as the need for written client representation and an agreement to allow the auditor to read any material issued by the client with audited financial statements, should also be explained. An engagement letter is useful in establishing the necessary understanding between the client and the independent auditor, and such a letter is recommended. In a governmental setting, those matters are typically included in a formal contract.

**3.03** The client responsibilities can best be explained by having a preaudit conference with the auditee (see paragraphs 3.23 and 3.24). It is good practice

to document the understandings from the preaudit conference in an engagement letter addressed to the officials having the authority to engage the auditor. Such an engagement letter should mitigate potential misunderstanding between the auditor and the client.

**3.04** In addition to the requirements of SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), *Government Auditing Standards*, chapter 5, paragraphs 5.5 through 5.8 requires auditors to communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. This communication may be oral or written. Auditors may use an engagement letter to communicate such information. If the information is communicated orally, auditors should document the communication in the working papers. Auditors should communicate the following information:

- a. The auditors' responsibilities in a financial statement audit, including their responsibilities for testing and reporting on internal controls and compliance with laws and regulations.
- b. The nature of any additional testing of internal controls and compliance required by laws and regulations. For example, auditors may be required to comply with the additional requirements of the Single Audit Act, OMB Circular A-128, OMB Circular A-133, or other state and local laws and regulations.

To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing and reporting on internal controls and compliance, auditors should contrast the responsibilities in *a* and *b* with other financial related audits of controls and compliance (such as an opinion on the internal control structure over financial reporting). See *Government Auditing Standards*, paragraphs 5.9 and 5.10, for further guidance.

## Identification of the Engagement Reporting Objectives

**3.05** Identification of the specific reports to be issued should be an early step in planning an audit. For example, in an audit or engagement conducted in accordance with GAAS, the auditor may be required to report on any or all of the following:

- GPFS of the reporting entity, including required supplementary information, where applicable
- Comprehensive annual financial report (CAFR) covering the GPFS and combining and individual fund and account group financial statements, schedules, and statistical tables. (The auditor may report on the combining and individual fund financial statements presented separately or in relation to the GPFS.)
- Financial statements of a component unit, including required supplementary information, where applicable
- Financial statements of a department or agency
- Individual fund financial statements
- Special reports on, for example, compliance with bond indentures, or requirements of federal or state grants, regulatory agencies, or state auditors

Chapter 18, "Auditor's Reports on Basic or General-Purpose Financial Statements," discusses and illustrates reporting on the government's financial statements. Exhibit 18.1 illustrates the relationship that exists in the financial reporting pyramid.

**3.06** The auditor may be engaged to expand the scope of the engagement for other purposes—for example, to issue single audit reports (the Single Audit Act of 1984) related to federal financial assistance programs as described in Part VII, “Audits of Federal Financial Assistance,” or to review the CAFR submitted to either the GFOA or the Association of School Business Officials (ASBO) to determine if the report meets their respective certificate program requirements. In all cases, care should be exercised to assure that the reporting requirements of the engagement are clearly defined, preferably in a written engagement letter or contract.

## Determination of Principal Auditor

**3.07** As previously discussed, the GASB Codification recognizes general-purpose financial statements as an appropriate reporting vehicle for governmental units. As discussed in GASB Cod. sec. 2100, related government activities or component units that meet the defined criteria are required to be included in the GPFS of the financial reporting entity. That requirement has resulted in the frequent inclusion of component units whose financial statements are audited by auditors other than those engaged by the primary government. In some cases the assets, liabilities, revenues, or expenditures (or expenses) of one or more component units may exceed those of the primary government. Those circumstances have raised questions about who is the principal auditor of the financial statements of the reporting entity. Paragraph .02 of SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543.02), requires a decision as to whether the auditor’s participation in the audit is sufficient to enable the auditor to serve as the principal auditor and to report as such on the financial statements.

**3.08** Considering the requirements of SAS No. 1, section 543 (AICPA, *Professional Standards*, vol. 1, AU sec. 543) and the nature of governmental units and their financial statements, an auditor should meet both of the following criteria in order to serve as the principal auditor:

- a. Engagement by the primary government as the principal auditor of the financial reporting entity
- b. Responsibility for auditing at least the general fund, or the primary operating fund if no general fund exists, of the primary government

Having met the principal auditor criteria, the auditor of the primary government is required to exercise the responsibilities of that position. Those responsibilities include confirming the independence of the other auditors (see paragraphs 3.45 and 3.46) and evaluating any adjustment, combination, or reclassification of component unit financial data to conform to the presentation in the GPFS of the reporting entity.

**3.09** In accordance with SAS No. 1, section 543, the principal auditor should decide whether to make reference in his or her opinion to the audit(s) of the other auditor(s). If the part of the audit that was done by another auditor is referred to, the disclosure of the magnitude of the portion of the financial statements audited by the other auditor should also include an identification of the fund types and account groups (if blended) or the component unit columns (if discrete). Examples A.12(A), “Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function, or Activity by Other Auditors,” A.12(B), “Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements When One Fund or Component Unit Representing

Less Than All of a Fund Type Has Been Audited by Other Auditors;" and A.13, "Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of *All* of a Fund Type by Other Auditors" in appendix A, "Illustrative Auditor's Reports," present illustrative auditor's reports for the principal auditor's reference to the audits of other auditors in various circumstances.

**3.10 Responsibilities of Component Unit Auditor.** The auditor of a component unit may or may not be the same as the auditor of the primary government. In those circumstances, it is important that an appropriate professional relationship be established between the two auditors. The auditor of the primary government (the principal auditor) assumes certain responsibilities under SAS No. 1, section 543. The component unit auditor may be required to facilitate the principal auditor's execution of professional responsibilities. In addition, the component unit auditor may be expected to participate in presenting financial statements of the component unit on a different basis of accounting or fiscal year not typically prepared by the component unit for its separate reporting. It is important that the auditors and their clients reach an early agreement on reporting responsibilities, including how any additional preparation and audit costs will be borne by the entities. Coordination of audit responsibilities is equally important in planning a single audit. (See chapter 21, "Single Audit Planning.")

**3.11 Responsibilities as Joint Auditor.** With the encouragement of governments, certified public accounting (CPA) firms occasionally agree to perform audits on a joint venture or subcontract basis. Independent auditors participating in a joint audit should arrive at a formal understanding of their respective responsibilities, usually through a contract, including the following:

- Signing the audit report
- Determining the compensation of the parties
- Supervising the engagement
- Documenting the engagement in the working papers
- Establishing review procedures

The responsibility for signing the audit report usually dictates the extent of the working paper review and other professional requirements imposed on the participants. (See chapter 16, "State Governments," paragraphs 16.10 through 16.14, and chapter 21, "Single Audit Planning," paragraphs 21.15 through 21.20, herein, for a discussion of joint audits.)

## Audit Focus on Financial Statement Format and Materiality

**3.12 GASB Cod. sec. 2200.101** states that every governmental unit should prepare and publish, as a matter of public record, a CAFR that encompasses all funds and account groups. The CAFR should contain (a) GPFS by fund type and account group, and (b) combining statements by fund type and individual fund statements. GASB Cod. sec. 2200 addresses various aspects of financial reporting, including the requirements applicable to the GPFS. GPFS are required to be presented in a combined statement format that presents fund types, and account groups, and discretely presented component units in side-by-side columns. The omission of an existing fund type, account group, or component unit from the GPFS is a departure from GAAP. Examples A.5 through A.7 in appendix A, "Illustrative Auditor's Reports," illustrate the report format in these circumstances when the departure from GAAP is mater-

ial. Therefore, audit scope should be set and materiality evaluations should be applied at the fund type, account group, and discretely presented component unit column(s) when reporting on GPFS, or at the individual fund statement level when reporting on the GPFS, combining and individual fund financial statements in a CAFR, or as may be required for other purposes—such as the requirements for an audit to be performed in accordance with single audit requirements, as discussed in chapter 5, “Testing and Reporting on Compliance With Laws and Regulations,” and chapter 20, “Introduction to the Single Audit,” respectively.

**3.13** With respect to the auditor’s reports on the GPFS, the omission of a fund type or account group, for any reason other than the nonexistence of the related fund type or account group, requires a qualification of the auditor’s report.

## Understanding the Governmental Unit

**3.14** Background information relating to the operations of the governmental unit should be obtained in order to provide a basis for subsequent audit planning procedures. Background information useful to planning may include the following:

- The composition of the reporting entity
- The form of government, for example, a legislative body with governor or mayor as the administrator versus a legislative body with an appointed manager
- Organizational structure, including the names and experience of top management
- Laws, statutes, and regulations governing the general operations of the governmental unit
- The nature of any joint ventures
- Factors affecting the continued functioning of the governmental unit, for example, the presence or absence of taxpayer initiatives that limit the taxing authority’s growth, expenditure growth, or the addition of incremental services
- The existence and functions of an audit committee or other group or individual with oversight responsibility for financial reporting
- Primary sources of revenue (for example, property taxes, appropriations, grants, contracts, service charges)
- Services provided by the governmental unit
- Services provided by separate governmental departments and independent entities (for example, hospitals, schools, redevelopment agencies) and their relationship to the governmental unit to be audited
- Number of employees by governmental function
- An assessment of accounting and financial reporting systems; if automated, a general understanding of the type of electronic data processing (EDP) equipment used, personnel involved, and similar background information, including software packages and operating systems
- The number and nature of funds and account groups
- Departures from GAAP in prior financial statements that could lead to report qualifications
- The nature of any compliance auditing requirements
- Special reporting requirements

**3.15** The foregoing information generally can be obtained from authorizing statutes, charters, budget documents, recent official statements, prior comprehensive annual financial reports, the request for proposal, other documents, and discussions with key members of management.

## Consideration of the Internal Control Structure

**3.16** As discussed in chapter 4, “Internal Control Structure,” to plan the audit, the auditor should have a sufficient understanding of each of the three elements (control environment, accounting system, and control procedures) of the internal control structure of the entity. He or she should know about the design of relevant policies, procedures, and records, and whether they have been placed in operation. In deciding where to focus the procedures undertaken to gain an understanding of the internal control structure, the auditor should consider, among other matters, judgments about materiality for various account balances and transaction classes and the information obtained from the evaluation of the risk factors described in paragraph 3.18.

**3.17** For those internal control structure policies and procedures relevant to audit planning, the auditor must assess and document the control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The independent auditor uses the knowledge he or she has gained of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests on financial statement amounts.

## Factors Affecting the Risk of Financial Statement Misrepresentation

**3.18** In developing an audit plan, the auditor should consider factors influencing the risk of errors, irregularities, or illegal acts causing financial statements to be materially misstated. This should include an evaluation of the following factors:

- The existence of laws, rules, and regulations that may have a direct and material effect on amounts reported in the financial statements
- Unusual or unexpected transactions, events, amounts, ratios, or trends noted as a result of analytical procedures
- The existence of material accounting estimates
- The existence of many contentious or difficult accounting issues
- The existence of significant difficult-to-audit transactions
- The appearance of an unduly aggressive attitude on the part of management toward financial reporting
- The management’s poor reputation in the governmental management community
- The circumstance that the governmental unit is a new client and sufficient prior audit information is not available from the predecessor auditor (see paragraph 8 of SAS No. 7 [AICPA, *Professional Standards*, vol. 1, AU sec. 315.08])
- The potential for management misrepresentation
- The susceptibility of assets to unauthorized use or disposition
- The effectiveness of the overall financial controls, including the ability to operate within approved budgets and issue timely and accurate financial reports

- The appropriate segregation of duties and responsibilities
- The dependence of the governmental unit on one or more individuals to operate key programs or manage the budget or financial reporting function
- The effectiveness of the internal audit function
- Turnover of key personnel
- Qualifications of key personnel
- Federal or state requirements for expanded audit scope
- Qualifications in auditors' reports for prior years
- The reduction or elimination of federal or state grant funds to finance key local programs
- The ability of key subsidiary accounting systems to produce data necessary to support financial statements
- Decentralized or centralized records

## Audit Approach

**3.19** The auditor should design an effective audit approach when planning the engagement. Because governmental units often maintain numerous funds and account groups, audit tests are most efficient if they are designed to avoid repetitive procedures. However, if one or more activities of the governmental unit are operated autonomously, they may need to be tested separately.

**3.20** The information obtained from the above-mentioned procedures should be used to evaluate the risk that material misstatements may exist in the financial statements and to establish acceptable levels of audit risk in view of the perceived levels of detection risk. These evaluations should be used to develop an audit program.

**3.21** The auditor should consider the nature, timing, and extent of the work to be performed and develop an audit program. The auditor should be aware that as the audit progresses, the audit program may need to be modified because of changed conditions, for example, unexpected results from tests of the operating effectiveness of internal accounting controls, the presence of new information, or unanticipated activities of the government. SAS No. 22, as amended by SAS No. 77, *Amendments to SAS No. 22, Planning and Supervision*, No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU secs. 311, 341, and 623); SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339); and SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319); provide guidance on audit programs and other working paper documentation.

**3.22** A preliminary audit planning memorandum may be prepared describing the overall approach to the audit, including the following:

- Audit objectives
- Staffing levels and staff responsibilities
- Use of analytical procedures
- Responsibility for and extent of supervision
- Budgeted hours and completion dates for audit segments
- Materiality levels used for planning purposes
- Risk assessments relating to the understanding of internal control structure elements obtained to plan the audit

- Guidelines relating to working paper form and content
- Use of specialists

The audit planning memorandum may be used as a basis for audit staff planning conferences as well as a means of monitoring the progress of the audit.

## Preaudit Communication With the Client

**3.23** It may be desirable to hold a preaudit conference with the client to discuss the responsibilities of both the client and the auditor. Key elements of the preaudit conference include—

- Identification of audit staff.
- The independent auditor's responsibility for communicating reportable conditions under SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).
- Audit timing, including dates for the following:
  - Availability of records.
  - The start of the audit, including the start of an alternative course of action should the records not become available as planned.
  - The required delivery of the report.
- Reports to be provided by the auditor pursuant to the terms of the engagement.
- Purpose, nature, scope, and limitations of the audit.
- Applicable audit standards and guidance, including the auditor's responsibility for communicating with management if the auditor becomes aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement.
- Communication of matters required by paragraphs 5.5 through 5.8 of *Government Auditing Standards* (see paragraph 3.04).
- The auditor's responsibilities for—
  - Discovering and reporting irregularities and illegal acts, contractual compliance violations, and questioned costs.
  - Communicating certain matters to the audit committee or other party responsible for oversight of the financial reporting process.
  - Preparing the annual report or other involvement in conformance with any ASBO and GFOA certificate program requirements.
- The client's responsibility for—
  - Financial statement assertions and a management representation letter accepting such responsibilities.
  - The internal control structure.
  - Identifying all laws, rules, and regulations that may have a direct and material effect on the financial statement amounts and for disclosing all instances of noncompliance.
- The auditor's expectations concerning the availability of lawyer letters.
- Identification of federal and state financial assistance programs if a single audit or program audit is to be performed.
- Internal audit and clerical assistance the auditor expects to receive from the client.



- Nature and extent of any additional audit tests to be performed at the client's request.
- Understanding of fee and billing arrangements.

3.24 These preaudit conference understandings may be communicated in an engagement letter addressed to the board or official with the authority to engage the auditor.

## Determining Whether an Additional Audit is to be Performed

3.25 As part of the planning process, the auditor needs to be aware of whether the entity is subject to additional audit requirements that are not encompassed by the terms of the engagement. If the auditor becomes aware that an audit in accordance with GAAS will not satisfy the relevant legal, regulatory, or contractual requirement, the auditor should make management aware of the type of audit that is required (for example, an audit in accordance with *Government Auditing Standards* or a single audit in accordance with OMB Circular A-128 or A-133). (See chapter 5, "Testing and Reporting on Compliance With Laws and Regulations," paragraphs 5.04 and 5.05 for further discussion of the auditor's responsibilities in this situation.)

## Determining Compliance Requirements

3.26 Paragraphs 3 through 7 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.03 through .07), provides guidance on the auditor's responsibility for testing compliance requirements that could have a direct and material effect on the financial statements. In planning the audit, the auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in an entity's financial statements. The auditor should also assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in an entity's financial statements and obtain an understanding of the possible effects on the financial statements of such laws and regulations. See Part VII, "Audits of Federal Financial Assistance," for a discussion of the auditor's responsibility for testing compliance requirements in a single audit.

## Performing Analytical Procedures

3.27 In planning the audit, the auditor should perform analytical procedures to identify significant matters that may require audit emphasis. However, overall analytical procedures are generally less effective when applied to the combined financial statements. Such procedures should be directed at a level sufficient to understand the effect of significant events or actions taken by management. See SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329).

## Developing Audit Programs

3.28 In planning an audit, according to SAS No. 22, as amended by SAS No. 77, an auditor should prepare a written audit program or set of programs.

Efficient and effective audit programs incorporate consideration of financial statement assertions, specific audit objectives, and appropriate audit procedures to achieve the specific objectives.

**3.29** The GASB Codification contains the accounting and reporting standards for governmental units. Part II, “The State and Local Government Audit—Governmental Funds and Account Groups” and Part III, “The State and Local Government Audit—Proprietary and Fiduciary Funds,” herein, set forth general financial statement assertions, audit objectives, and audit procedures that may be considered in developing audit programs. Appendix B, “Illustrative Internal Control Structure Questions—State and Local Governmental Units,” contains a list of illustrative internal control structure questions that an auditor might raise concerning a state or local government. The auditor plans his or her audit using the GASB Codification and this guide to meet the objectives of each specific audit engagement.

**3.30 *Financial Statement Assertions.*** In forming an opinion on the financial statements, “Assertions,” according to paragraph 3 of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.03), “are representations by management that are embodied in financial statement components.” Assertions can be classified in the following broad categories:

- *Existence or Occurrence.* Reported assets and liabilities actually existed at the balance-sheet date and transactions reported in the operating statement actually occurred during the period covered.
- *Completeness.* All transactions and accounts that should be included in the financial statements are included, and there are no undisclosed assets, liabilities, or transactions.
- *Rights and Obligations.* The entity has rights to the assets, and the liabilities are obligations of the entity at a given date.
- *Valuation or Allocation.* The assets, liabilities, revenues, and expenditures/expenses are included in the financial statements at an appropriate amount.
- *Presentation and Disclosures.* The assets, liabilities, revenues, and expenditures/expenses are properly classified, described, and disclosed in the financial statements.

**3.31 *Developing Audit Objectives.*** An auditor develops specific audit objectives to obtain evidential matter to support the financial statement assertions. An audit objective is, in effect, an assertion translated into terms relevant to a specific account.

**3.32 *Selecting Audit Procedures.*** The basic requirements for selection of audit procedures are set forth in SAS No. 31 (see “Use of Assertions in Developing Audit Objectives and Designing Substantive Tests,” AU sec. 326.13).

## Other Matters

**3.33** Certain other matters unique to audits of governmental units are also discussed in this chapter because of their potential relevance to the audit planning process. Those matters include working paper documentation, audit follow-up, inquiries of a client’s lawyer (lawyer letters), the applicability of other AICPA audit and accounting guides, component unit disclosure issues, unresolved accounting and auditing issues, and auditor independence. Also, because governmental administration changes are common, the independent

auditor may have difficulty obtaining representations from management because the officials have left the employ of the government. An interpretation of SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), entitled, *Management Representations When Current Management Was Not Present During the Period Under Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9333.05 and .06), discusses auditors' responsibilities for obtaining written representations in an audit engagement when current management was not present during the period under audit. In this situation, the Interpretation states that auditors should obtain written representations from current management on all periods covered in their report. The auditor should consider such circumstances early in the engagement. Failure or inability to obtain written representations from management may result in a limitation on the scope of the audit sufficient to preclude the auditor from expressing an unqualified opinion. See SAS No. 19 and chapter 17, "Concluding the Audit," for additional discussion of management representation letters.

## Working Paper Documentation

**3.34** SAS No. 41 provides guidance on the preparation and maintenance of working papers as required by GAAS. Also, Appendix K contains an Interpretation of SAS No. 41 titled, *Providing Access to or Photocopies of Working Papers to a Regulator*. That interpretation provides guidance on responding to requests by governmental agencies (regulators) that auditors provide them with access to audit working papers.

**3.35** *Government Auditing Standards* adds an additional working paper standard for financial audits that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. Specifically, *Government Auditing Standards* states that working papers should contain—

- a. The objectives, scope, and methodology, including any sampling criteria used.
- b. Documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records.
- c. Evidence of supervisory reviews of the work performed.

## Audit Follow-Up

**3.36** *Government Auditing Standards* includes an additional field work standard in the area of audit follow-up. Paragraph 4.10 of *Government Auditing Standards* states: "Auditors should follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. They should do this to determine whether the auditee has taken timely and appropriate corrective actions. Auditors should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit."

## Lawyer Letters

**3.37** Lawyer letters of the type requested in commercial audits should be requested (see SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AICPA, *Professional Standards*, vol. 1, AU sec. 337]).

They may be requested, for example, from the city attorney or the state attorney general, and outside counsel used on significant matters. If the government's chief legal officer or its outside legal counsel is unwilling or unable to provide all the information the auditor needs to form a conclusion on litigation, claims, and assessments, the auditor should plan early in the engagement to take the appropriate steps and discuss with the client the qualification that may be necessary when expressing an opinion. If inside counsel provides the assessment of litigation, claims, and assessments, Interpretation No. 8, "Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments," of SAS No. 12 should be considered (AICPA, *Professional Standards*, vol. 1, AU sec. 9337.24).

## Applicability of Other AICPA Audit Guidance

**3.38** Large governments may have a variety of component units, and planning should involve not only identifying applicable component units of the reporting entity, but also the accounting principles and financial reporting practices that should be used by specific component units. In addition to this guide, four other guides have been issued by the AICPA that address organizations involved in activities often conducted by units of government. Their applicability in a governmental environment should be determined. The following discussion provides guidance until these issues are further addressed by the GASB.

**3.39 *Audits of Health Care Organizations.*** Government-operated health care entities generally should be reported as enterprise funds in accordance with the requirements of the AICPA Audit and Accounting Guide *Health Care Organizations*.

**3.40 *Audits of Colleges and Universities.*** See chapter 1, "Overview," paragraph 1.05, herein, for a discussion of the applicability of the AICPA Industry Audit Guide *Audits of Colleges and Universities*.

**3.41 *Audits of Certain Nonprofit Organizations.*** Some governmental units conduct activities such as operating libraries, museums, cemeteries, and zoological parks. The AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* may be useful in identifying audit objectives and related audit procedures. (Auditors should note that although *Audits of Certain Nonprofit Organizations* has been superseded by the recently issued Audit and Accounting Guide *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment.) See chapter 1, "Overview," paragraph 1.08, herein, for additional information.

**3.42 *Audits of Employee Benefit Plans.*** Public employee retirement systems (PERS) are similar to private sector plans in many respects. As a result, the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* may be useful in identifying audit objectives and related audit procedures.

## Disclosure Issues

**3.43** As described in the health care and college and university audit and accounting guides, financial statements of those entities usually employ a multiple-fund-type structure often including, among others, general unrestricted funds, restricted funds, endowment or trust funds, and plant funds. If such an entity is included in a government's financial statements, its financial position and results of operations included in the GPFS of the government

should be based on all of its financial activity in accordance with GASB Cod. sec. 2600. Significant disclosures that might be obscured, such as the extent of restricted assets and liabilities, should be provided in the notes to the financial statements or through alternative statement classifications. When separate financial statements for the component unit are issued, the notes thereto describing the separate activities should describe clearly the relationship of the component unit to the primary government.

## Unresolved Accounting and Auditing Issues

**3.44** As of the date of this guide, there are a number of projects under way by GASB and various government agencies that could establish new standards and principles or modify existing ones. Therefore, when planning and conducting an audit engagement, the auditor should refer to the most recent pronouncements of the GASB, the AICPA, the GAO, the OMB, and other pertinent government agencies. The auditor should also refer to the annual AICPA Audit Risk Alert *State and Local Governmental Developments* for further information about projects that may be under consideration.

## External Auditor Independence

**3.45** GASB Cod. sec. 2100 requires the financial statements of many agencies, organizations, and authorities (component units) previously considered to be autonomous to be combined with the financial statements of another governmental unit (primary government) to form a financial reporting entity. Ethics Interpretation 101-10 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12) discusses the effect on independence of relationships with entities included in governmental financial statements. Among other things, the Interpretation requires the following:

- Auditors issuing a report on the general-purpose financial statements of the financial reporting entity must be independent of the financial reporting entity, as defined in the Interpretation. However, independence is not required with respect to a related organization if the financial reporting entity is not financially accountable for the organization and the required disclosure does not include financial information (for example, the ability to appoint or the appointment of governing board members).
- Auditors who are auditing the financial statements of a material fund type, fund, account group, or component unit of the financial reporting entity or entity that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity but are not auditing the primary government, should be independent with respect to those financial statements and those of the primary government. Auditors are not required to be independent of other fund types, funds, account groups, or component units of the financial reporting entity or entities that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity provided they are not financially accountable for or to the auditee organization or cannot significantly influence the auditee organization through financial transactions or through common policy-making individuals or governing board membership.
- Auditors who are not auditing the primary government but are auditing the financial statements of one or more fund types, funds, account groups, or component units of the financial reporting entity or entities

that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity that alone or in the aggregate are immaterial to the general-purpose financial statements, should be independent with respect to those financial statements and should not be associated with the primary government in any capacity described in Interpretation 101-1-B, *Interpretation of Rule 101* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02). If auditors are auditing immaterial fund types, funds, account groups, or component units of the financial reporting entity or entities that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity that, when aggregated, are material to the financial reporting entity, auditors should be independent of those financial statements and the primary government.

**3.46** An auditor expressing an opinion on the financial statements of a governmental reporting entity should take reasonable steps to confirm the independence of auditors of fund types, funds, account groups, component units, or entities that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity in accordance with SAS No. 1, section 543.

## Chapter 4

# Internal Control Structure

### Introduction

**4.01** This chapter addresses the auditor's responsibility for consideration of the internal control structure in audits of financial statements of governmental entities. Chapter 23, "Performing the Audit of Federal Financial Assistance Programs," discusses the auditor's consideration of the internal control structure used in administering federal financial assistance programs under the Single Audit Act of 1984.

### Responsibilities Under Generally Accepted Auditing Standards

**4.02** SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with GAAS. It describes the three elements of an internal control structure (the control environment, the accounting system, and the control procedures) and explains how an independent auditor should consider the internal control structure in planning and performing an audit. To plan the audit, the independent auditor should have a sufficient understanding of each of the three elements, which he or she obtains by performing procedures that will facilitate an understanding of the design of policies and procedures relevant to audit planning, and should evaluate whether these have been placed in operation.<sup>7</sup>

### Understanding of Internal Control Structure

**4.03** In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests to detect the occurrence of misstatements. Other sources of such knowledge include previous audits and the understanding of the government environment. The auditor also considers assessments of inherent risk, judgments about materiality, and the complexity and sophistication of the government's operations and systems—including whether the method of controlling data processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As the operations and systems of an entity become more complex and sophisticated, it may be necessary to devote more attention to internal control structure elements to gain the understanding necessary to design effective substantive tests.

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<sup>7</sup> In December 1995, SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, was issued which revises the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. Since SAS No. 78 is not effective for audits of financial statements until periods beginning on or after January 1, 1997 (early application is permitted), this Guide has not been updated to include the new requirements.

## Understanding of Control Environment

**4.04** The auditor should have sufficient knowledge of the control environment to understand management's and the governing body's attitude, awareness, and actions concerning the control environment. The auditor should focus on the substance rather than the form of management's policies, procedures, and related actions, bearing in mind that the establishment of appropriate policies and procedures may not be followed by equally appropriate action. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.

## Understanding of Accounting System

**4.05** The auditor should have sufficient knowledge of the accounting system to understand—

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How the transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, along with how the computer is used to process data.
- The financial reporting process used to prepare the financial statements of the entity, including significant accounting estimates and disclosures.

## Understanding of Control Procedures

**4.06** Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor gains an understanding of the control environment and accounting system, he or she is also likely to gain knowledge of some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control procedures he or she has acquired from an understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components but should be obtained for each material account balance, transaction class, or disclosure component.

## Procedures to Obtain Understanding

**4.07** In gaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures that will provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. This know-



ledge is ordinarily acquired through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular policy or procedure, and the nature of the entity's documentation of specific policies and procedures.

## Documentation of Understanding

**4.08** The auditor should document his or her understanding of the entity's internal control structure elements required to plan the audit. The form and extent of this documentation are influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex government may include flowcharts, questionnaires, or decision tables. For a small government, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

**4.09** After acquiring an understanding of the elements of the internal control structure, the independent auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. Control risk is defined by SAS No. 55 as the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the internal control structure policies and procedures. Control risk may be assessed at the maximum level for financial statement assertions for which policies and procedures are unlikely to be effective or because evaluating their effectiveness would be inefficient. Alternatively, for purposes of audit efficiency, the auditor may plan to assess control risk at below the maximum level by performing tests of controls to evaluate the effectiveness of policies and procedures relevant to specific financial statement assertions. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls. After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient. Paragraphs 39 and 43 through 47 of SAS No. 55 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.39 and .43 through .47) provide further guidance.

**4.10** In acquiring an understanding of the internal control structure, the auditor must consider the computer controls as well as the controls over the manual portions of the system. A review of both general and application controls should be considered a part of the assessment of control risk. When an entity uses a service organization to process its transactions, SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324) provides guidance to the auditor in considering the effect of the service organization on the internal control structure of the entity.

4.11 The auditor should consider whether any noted deficiencies in such internal control structure policies and procedures should be reported in accordance with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

## Responsibilities Under Government Auditing Standards

4.12 *Government Auditing Standards* does not prescribe any additional field work standards with respect to the internal control structure beyond that required in an audit conducted in accordance with GAAS. *Government Auditing Standards*, chapter 4, paragraphs 4.22 through 4.33, provides additional guidance on four aspects of internal controls that are important to the judgments auditors make about audit risk and about the evidence needed to support the opinion on the financial statements. These aspects are the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessments.

4.13 The significant points made by the *Government Auditing Standards* guidance on internal controls are summarized as follows:

- a. Auditors' judgments about the control environment may influence (either positively or negatively) judgments about specific control procedures.
- b. Safeguarding controls are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses material to the financial statements. Therefore, understanding safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- c. Controls over compliance with laws and regulations are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.
- d. Control risk assessments are important in determining the nature, timing, and extent of audit tests to be performed. *Government Auditing Standards* reminds auditors that when control risk is assessed below the maximum for a given financial statement assertion, the need for evidence from substantive tests of that assertion is reduced. Auditors are not required to assess control risk below the maximum and rely on controls. However, auditors may find it efficient to do so for larger clients or those with complex operations. The auditors' ability to rely on controls is directly related to the evidence obtained to show that the controls work. Auditors may find it necessary to reconsider assessments of control risk when substantive tests detect misstatements.

4.14 *Government Auditing Standards*, however, does require the auditor to report on internal controls. The report on the internal control structure can either be issued separately or in the report on the financial statements. Therefore, the report on the financial statements should either (1) describe the scope of the auditor's testing of internal controls and present the results of those

tests, or (2) refer to a separate report containing that information. In the report on the internal control structure (whether issued separately or in the report on the financial statements), auditors should identify reportable conditions in internal controls, including separate identification of material weaknesses (see paragraph 4.15 below). *Government Auditing Standards*, chapter 5, paragraphs 5.15 through 5.17 and 5.26 through 5.28, discusses reporting on internal controls. See also paragraph 24.04 herein.

**4.15** Reporting on the internal control structure under *Government Auditing Standards* differs from reporting under SAS No. 60. *Government Auditing Standards* requires written reporting on the internal control structure in all audits; SAS No. 60 requires communication only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including the identification of those that are individually or cumulatively material weaknesses. SAS No. 60 permits, but does not require, the auditor to identify and communicate separately, as material weaknesses, those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, not addressed by SAS No. 60:

- a. Description of the scope of the auditor's testing of internal controls
- b. Deficiencies in the internal control structure that are not considered reportable conditions

**4.16** Paragraph 4.17 herein addresses reporting the scope of the auditor's work. Paragraphs 4.18 and 4.19 address the communication of deficiencies in internal controls that are not reportable conditions. Reports on the internal control structure are illustrated in appendix A, "Illustrative Auditor's Reports," of this guide.

## Scope of the Auditor's Work

**4.17** *Government Auditing Standards* requires that auditors report the scope of their testing of internal controls and present the results of those tests. If the tests they performed did not exceed those the auditor considered necessary for a financial statement audit, then a statement that the auditor obtained an understanding of internal controls, and assessed control risk would be sufficient to satisfy this requirement. Auditors should also report whether or not the tests they performed provide sufficient evidence to support an opinion on internal controls.

## Deficiencies in Internal Controls That Are Not Reportable Conditions

**4.18** Paragraph 5.28 on page 58 of *Government Auditing Standards* states:

When auditors detect deficiencies in internal controls that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated other deficiencies in internal controls in a management letter to top management, they should refer to that management letter when they report on controls. All communications to the auditee about deficiencies in internal controls should be documented in the working papers.

**4.19** To comply with this requirement, auditors should communicate to management the deficiencies in the internal control structure that have come to their attention but which they believe are not significant enough to be report-

able conditions, as defined in SAS No. 60. If the auditor has communicated other deficiencies in the internal control structure in a management letter to top management, he or she should refer to that management letter when reporting on internal controls. The report on internal controls should be modified to include a statement such as the following:

However, we noted other matters involving the internal control structure and its operation that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1.

### Reportable Conditions

**4.20** When the auditor has noted reportable conditions in a financial statement audit conducted in accordance with *Government Auditing Standards*, the auditor's report on the internal control structure should contain the elements described in chapter 24, "Reporting Under the Single Audit Act and OMB Circular A-128." Paragraph 17 of SAS No. 60 (AICPA, *Professional Standards*, vol. 1, AU sec. 325.17) prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he or she may issue a report, such as that illustrated in appendix A, Example A.25(B), to satisfy the requirements of *Government Auditing Standards*.

### Responsibilities Under the Single Audit Act of 1984

**4.21** The Single Audit Act of 1984 expands on the requirements of GAAS and *Government Auditing Standards* and requires the auditor to determine and report whether the entity has internal controls that provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. The auditor's responsibilities under the Single Audit Act are discussed in Part VII, "Audits of Federal Financial Assistance."

### Industry Characteristics Affecting the Control Environment

**4.22** Government operations include a number of characteristics and internal control structure features that differ from those in the private sector and that may significantly affect the control environment, such as the following:

- Budget and appropriation systems
- Encumbrance systems
- Personnel control systems
- Procurement and contracting systems
- Grants monitoring/management
- Management

### Budget and Appropriation Systems

**4.23** Many government budgetary control systems have two primary objectives: (a) to determine that the proposed expenditures are allowed by the budget, and (b) to make sure that the proposed expenditures do not exceed budgeted and appropriated amounts. The budget and appropriation process often provides substantial direction and control over expenditures. Public budget hearings permit the press and public interest groups to influence anti-

pated levels of expenditures. Once adopted and appropriated, the budget becomes the expenditure authorization for operations. (See chapter 6, "The Budget," for additional internal control structure considerations related to the budget process.)

## **Encumbrance Systems**

**4.24** Encumbrances frequently are recorded in the accounting system. Recording encumbrances at the time of a legal obligation (generally when a contract is executed or a purchase order is placed with a vendor) rather than when the goods or services are received (when the actual payment liability is incurred) provides an additional level of control. Some governments extend this control to recording commitments (preencumbrances) when there is an intent to enter into a legal obligation. Depending on the applicable laws and regulations, encumbrances may expire at fiscal year end. Commitments almost always expire at the end of each year.

## **Personnel Control Systems**

**4.25** Within most units of government, the procedures required to add or delete personnel from the organization's payroll usually are well established. Union contracts, complex civil service regulations, or position classification systems designed to provide equity in job assignments, job protection, and other security to employees, require the implementation of specific controls. When coupled with budgetary controls, which are often in the form of position and salary ceiling limits, they reduce opportunities for discretionary hiring and termination. However, the position classification and control system requirements do not achieve their objectives unless they are executed properly and are linked to the payroll accounting system. Moreover, special units of government, such as public authorities, often are not under the same stringent controls as primary governmental units.

## **Procurement and Contracting Systems**

**4.26** Procurement techniques and the types of contracts and agreements used to acquire goods and services in governments frequently exceed the requirements of the private sector. Regulations surrounding the administration and use of procurement procedures by governments usually permit far less latitude and discretion than that commonly existing in the private sector. Because governmental procurement procedures usually provide for (a) public notice of procurement opportunities, (b) disclosure of procurement evaluation procedures, and (c) bidding or negotiation procedures, significant procurements in government are usually exposed to a high level of public scrutiny. Each of these procedures may enhance the internal control structure of governmental units.

## **Management**

**4.27** The administration of a governmental entity usually has executive and legislative components; in many cases, there is a judicial component as well. The executive branch of a government is responsible for instituting and maintaining a satisfactory internal control structure for operations. This structure should conform to the laws and regulations established by the legislative component. In addition, the judicial component frequently is quasi-independent from these other components. In a number of instances, for example, in some county governments, the courts have direct responsibility for their financial systems.

**4.28** Management's awareness of and attitude toward internal controls is part of the control environment that the auditor should evaluate early in an audit engagement. Management should understand its responsibility to implement and maintain an adequate internal control structure and should—

- Initiate procedures to detect areas of operation that are particularly vulnerable to errors, irregularities, and the misuse of assets, or circumstances that may adversely affect the reliability of the government's financial statements.
- Establish procedures to monitor and evaluate compliance with internal control structure policies.
- Institute timely action to correct identified internal control structure weaknesses.

**4.29** Management's perception of its responsibilities for the control environment can significantly affect the conduct of an audit.

## **Influence of Other Entities on the Internal Control Structure**

**4.30** Individuals and organizations, such as grantor agencies and internal auditors, may affect the internal control structure in a governmental organization.

### **Grantor Agencies**

**4.31** Organizations outside the governmental entity being audited may also have an effect on the internal control structure. For example, federal or state programs may provide a significant portion of a local government's revenues. The terms of the grant or entitlement agreements frequently impose considerable control requirements on the recipient. Grant provisions may relate not only to how funds are used, but also to accounting, reporting, and control structure requirements.

**4.32** Grantor agencies naturally are concerned with the quality of the internal control structure established by grantees to assure compliance with grant terms and conditions. The independent auditors are also concerned because the scope of the audit may be affected by the adequacy of the existing internal control structure. Failure to comply with the terms of grant agreements may give rise to contingent liabilities for the return of revenues, which may have a material impact on the financial statements. Thus, noncompliance becomes a factor in the auditor's ability to express an opinion on the financial statements of the grantee.

### **Internal Auditors**

**4.33** As in commercial enterprises, the internal auditors of governmental entities usually play a significant role in monitoring the internal control structure and making recommendations for improvement. The internal audit organization usually attempts to maintain its independence from the executive, legislative, or judicial branches, although, administratively, it may report to any one of them.

**4.34** The executive branches of state and federal governments frequently establish internal audit organizations within each operating department. Such a departmental internal audit organization is normally responsible for (a) the internal audit of departmental activity, and (b) the audit of grantees (beneficiaries) to whom the department provides funds in accordance with legislative programs.

**4.35** Auditors should recognize the variety of roles and perspectives that internal auditors may have within government and the effects on the organization's internal control structure. The presence of an internal audit function may affect an organization's internal control structure in two ways. First, an internal audit function usually increases the attention devoted to the internal control structure of the organization. Second, to the extent an internal audit function is responsible for a continuing evaluation of the internal control structure, it serves the important role of monitoring the control systems. SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), discusses the effects of internal audit organizations on the independent auditor's audit. Further, *Government Auditing Standards* requires that independent public accountants, governmental auditors, and internal auditors conducting audits pursuant to such standards comply with the same continuing education and quality control standards.

## Chapter 5

# Testing and Reporting on Compliance With Laws and Regulations

### Introduction

**5.01** SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801) provides general guidance when the auditor is engaged to test and report on compliance with laws and regulations in engagements, as defined below, under GAAS; *Government Auditing Standards*; the Single Audit Act of 1984; and OMB Circular A-128, and OMB Circular A-133. This chapter provides guidance on the auditor's responsibility to—

- a. Apply the provisions of SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316) and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317) relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities (see paragraphs 5.06 through 5.25 herein).
- b. Report on compliance with laws and regulations in audits conducted in accordance with *Government Auditing Standards* (1994 revision), issued by the Comptroller General of the United States (see paragraphs 5.26 through 5.41 herein).
- c. Establish an understanding with management regarding the type of engagement when engaged to test and report on program-specific audits or compliance with state or local laws and regulations (see paragraphs 5.45 through 5.48 herein).

Paragraphs 5.42 through 5.44 and Part VII, "Audits of Federal Financial Assistance," provide guidance on the auditor's responsibility to test and report on compliance with certain laws and regulations applicable to federal financial assistance programs in audits conducted in accordance with the Single Audit Act of 1984 and OMB Circular A-128, or with OMB Circular A-133, if applicable.

**5.02** Governmental entities, because they are established by and operate under numerous laws and regulations, are generally subject to many more legal constraints than are their nongovernmental counterparts. The management of the entity is responsible for ensuring compliance with the laws and regulations applicable to its activities. That responsibility encompasses identifying applicable laws and regulations and establishing internal control structure policies and procedures designed to provide reasonable assurance that the entity complies with those laws and regulations. The auditor's responsibility for testing and reporting on compliance with laws and regulations varies according to the terms of the engagement (paragraph 5 of SAS No. 74 [AICPA, *Professional Standards*, vol. 1, AU sec. 801.05]).



**5.03** Because of the variety of audit requirements to which entities receiving governmental financial assistance are subject, paragraph 21 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21) states that auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. If a proposal, contract, or engagement letter is used, an auditor should consider including a statement about the type of engagement and whether it is intended to meet specific audit requirements.

**5.04** Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Paragraph 22 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.22) states that GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.<sup>8</sup> For example, the auditor will be required to make this communication if an entity engages an auditor to perform an audit of its financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement, the entity also is required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*, issued by the Comptroller General of the United States
- The Single Audit Act of 1984 and OMB Circular A-128, *Audits of State and Local Governments*
- OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

**5.05** Paragraph 23 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.23) states that the communication required by paragraph 5.04 may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54.

## **Compliance Auditing in Audits Conducted in Accordance With Generally Accepted Auditing Standards**

**5.06** In an audit performed in accordance with GAAS, the auditor's responsibility for consideration of laws and regulations and how they affect the audit is described in SAS Nos. 54 and 53. Paragraph 5 of SAS No. 54 (AICPA,

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<sup>8</sup> For entities that do not have audit committees, "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

*Professional Standards*, vol. 1, AU sec. 317.05), equates the auditor's responsibility for detecting misstatements caused by certain illegal acts with the responsibility for other errors and irregularities:

The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts....However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se. The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities as described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.

**5.07** Paragraph 5 of SAS No. 53 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.05) describes the auditor's responsibility for detecting errors and irregularities as follows:

The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

**5.08** Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.<sup>9</sup> This responsibility exists for all audits conducted in accordance with GAAS.<sup>10</sup>

**5.09** GASB Cod. sec. 1200.103 indicates that governmental entities generally are subject to a variety of laws and regulations that affect their financial statements:

An important aspect of GAAP [generally accepted accounting principles] as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are reflected in the fund structure, bases of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting.

**5.10** Paragraphs 5.11 through 5.18 provide guidance on obtaining an understanding of the possible effects on a governmental entity's financial statements of laws and regulations that have a direct and material effect on the determination of financial statement amounts. Paragraphs 5.19 through 5.21 provide guidance on considering the risk, including control risk, that the financial statements could include material misstatements resulting from violations of such laws and regulations.

## Understanding the Effects of Laws and Regulations

**5.11** When performing an audit in accordance with GAAS, auditors should consider the federal, state, and local laws and regulations that are generally recognized to have a direct and material effect on the determination of financial

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<sup>9</sup> Paragraph 3.12 of this guide states that, for general-purpose financial statements, "audit scope should be set and materiality evaluations should be applied at the fund type, account group, and discretely presented component unit column(s) when reporting on the GPFS...."

<sup>10</sup> The auditor undertakes the same responsibility in an audit of financial statements conducted in accordance with *Government Auditing Standards*. See paragraphs 5.26 and 5.27 for further discussion.

statement amounts. This involves identifying laws and regulations that may have a direct and material effect on the determination of financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement. It is management's responsibility to identify the compliance requirements of the government. The auditor should consider discussing these requirements with the government's chief financial officer and, if necessary, with legal staff. Discussions with these officials should focus on those compliance matters included in the laws and regulations (including the government's charter and financial ordinances) that may require testing. If appropriate, contact should be made with the state auditor or a similar oversight organization to obtain its perspective on key compliance areas applicable to constituent communities (including state statutes, regulations, and uniform reporting requirements).

**5.12** The auditor should assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements. The auditor may consider performing the following procedures in assessing management's identification of such laws and regulations and in obtaining an understanding of their possible effects on the financial statements:

- a. Obtain publications pertaining to federal tax and other reporting requirements such as the U.S. Department of the Treasury and Internal Revenue Service (IRS) requirements, requirements pertaining to information returns, and regulations concerning arbitrage rebate calculation and refund.
- b. Consider contacting the audit, finance, or program divisions of those senior levels of government from which grants are received. They usually can be helpful in identifying compliance requirements and may identify compliance requirements separately or in a published audit guide.
- c. Consider knowledge about such laws and regulations obtained from prior years' audits.
- d. Discuss such laws and regulations with the entity's chief financial officer, legal counsel, or grant administrators. Obtain written representation from management regarding the completeness of management's identification (see paragraph 5.25).
- e. Review minutes of meetings of the legislative body of the governmental entity being audited for the enactment of laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements.
- f. Inquire of the program administrators of the governmental entities that provided the grants about restrictions, limitations, terms, and conditions under which such grants were provided.<sup>11</sup>
- g. Review information about compliance requirements available from the state societies of certified public accountants or associations of governments.

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<sup>11</sup> In assessing management's identification of requirements governing federal financial assistance programs and obtaining an understanding of their possible effects on the determination of financial statement amounts, the auditor may use as a reference source the *Compliance Supplement for Single Audits of State and Local Governments* and the *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*, issued by the Office of Management and Budget, and the *Catalog of Federal Domestic Assistance*. Herein, see appendix H, "Single Audit Literature," for single audits and other relevant literature.

- h.* Identify the sources of financial resources received by the entity and inquire about restrictions, limitations, terms, and conditions under which such financial resources are received. Review any directly related agreements (for example, loans and grants) and inquire about the applicability of any overall regulations of senior governments to the financial resources or accounting for the financial resources.
- i.* Obtain copies of the state constitution and state laws and review those sections that are relevant to the governmental entity. The sections of these documents pertaining to debt, taxation, budget, and appropriation and procurement matters are especially relevant.

### Examples of the Effects of Certain Laws and Regulations on a Governmental Entity's Financial Statements

**5.13** Some states have adopted rules governing the performance of compliance audits that clearly define the auditing and reporting expectations for audits of local governmental units.

**5.14** The adoption of specific compliance auditing requirements by state and local jurisdictions makes it imperative that auditors assess whether management has identified the specific compliance matters, as well as the related criteria for determining compliance, to be addressed within the scope of those audits.

**5.15** The following are examples of the types of laws and regulations that may have a direct and material effect on the determination of amounts in a governmental entity's financial statements. Such laws and regulations may be relevant to an entity whether or not it is legally required to prepare financial statements in accordance with GAAP.

- a. Reporting Entity.* For those entities required by law or regulation to prepare financial statements in accordance with GAAP, GASB Cod. sec. 2100 establishes criteria for determining the organizations, functions, and activities of government that should be included in the financial reporting entity. The financial reporting entity consists of the primary government, the organizations for which the primary government is financially accountable, and other organizations that, if not included, would cause the reporting entity's financial statements to be misleading or incomplete. In defining the financial reporting entity, management should consider applicable laws and regulations.
- b. Tax Reporting.* Report in accordance with federal and state requirements.
- c. Procurement.* Contract or make procurement through competitive bidding or negotiation.
- d. Appropriations.* Expend resources within authorized limits.
- e. Legal Authority for Transactions.* Execute transactions with proper legal authority.
- f. Establishment of Funds.* GASB Cod. sec. 1300 establishes the principles of fund accounting. It notes that—

Various types of legal provisions require the establishment of funds. At the state level, funds may be created pursuant to stat-

utes enacted by the legislative body. A local government's funds may be established by state statutes, or by local charters, ordinances, and governing body orders.

For example, a state statute may require that proceeds of a state gasoline tax be accounted for in a special revenue fund.

- g. *Budgetary Reporting.* An appropriated budget is the expenditure authority created by appropriation bills or ordinances that are signed into law and the related estimated revenues. GASB Cod. sec. 2400 requires that the GPFS present an aggregation by governmental fund type of the annual appropriated budgets, as amended, compared to actual results of operations.
- h. *Matching Requirements.* A grantor may require grantees to contribute their own resources toward carrying out the activity funded with a grant. A grant is a contribution of cash or other assets from another government to be used or expended for a specified purpose, activity, or facility. GASB Cod. sec. G60.109 states that if such matching requirements exist, revenue recognition depends on compliance with those requirements.
- i. *Restrictions on Expenditures.* The purposes for which the proceeds of certain governmental revenues may be expended are restricted by law. For example, a state constitution may require that the proceeds of a state gasoline tax be expended only for the maintenance of highways. Similarly, legislation enacting a housing grant program may require governmental entities receiving the grant to distribute the proceeds only to families meeting certain eligibility tests. Restrictions on expenditures do not necessarily require the establishment of a special revenue fund. GASB Cod. sec. 1300.107 notes that "resources restricted to expenditure for purposes normally financed from the general fund may be accounted for through the general fund provided that applicable legal requirements can be appropriately satisfied; and use of special revenue funds is not required unless they are legally mandated."
- j. *Taxing and Debt Limitations.* Certain governmental entities may be subject to laws and regulations that limit local government taxing authority, impose ceilings and other issuance criteria on debt, or limit the use of debt proceeds.
- k. *General Requirements.* Certain general requirements identified in the OMB's Compliance Supplements may have a direct and material effect on the determination of financial statement amounts in some circumstances. For example, certain costs not allowable by federal programs may have been inappropriately allocated to federal programs as indirect costs. Such an action would be a violation of OMB Circular No. A-87, *Cost Principles for State and Local Governments*, referred to in the allowable costs/cost principles general requirement, and could have a direct and material effect on the determination of cost-related amounts in the entity's financial statements.

**5.16** For these and other compliance matters within the scope of the audit, the auditor should seek guidance from affected local officials, state officials with oversight responsibility, and appropriate legal counsel.

**5.17** The GASB Codification also includes requirements to disclose violations of certain laws and regulations. GASB Cod. sec. 2300.106 states:

Notes to the financial statements essential to fair presentation at the GPFS [general-purpose financial statements] level include . . . [h.] Material violations of finance-related legal and contractual provisions.

The auditor's consideration of the adequacy of such disclosure includes an evaluation of the governmental entity's compliance with laws and regulations that could have a direct and material effect on the determination of financial statement amounts.

**5.18** GASB Cod. sec. I50.161 to I50.162 specifically requires governmental entities to disclose the types of investments they are legally authorized to make and any violations of legal or contractual provisions for deposits and investments. When these disclosures have been made by management, the auditor should also evaluate a governmental entity's compliance with legal provisions for deposits and investments. The auditor's responsibility to evaluate compliance with these legal provisions is based on the disclosure requirements specified by GAAP.

## Considering Risk

**5.19 *Factors Influencing Audit Risk.*** SAS No. 53 cites matters the auditor should consider in assessing audit risk at the financial-statement level and at the account balance or class of transactions level. Certain of these matters are relevant to the auditor's consideration of the risk of material misstatement of the financial statements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. For example, if a governmental entity is decentralized without adequate monitoring, the risk of material misstatement at the financial statement level might be increased. The risk of material misstatement related to particular assertions at the level of the account balance or class of transactions might be influenced by the nature, cause, and amount of known and likely misstatements detected in prior audits and the competence of personnel assigned to processing data that affect the account balance or class of transactions.

**5.20 *Internal Control Structure.*** SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires the auditor to acquire an understanding of the internal control structure that is sufficient to plan the audit and to assess control risk for the assertions embodied in the financial statements (see chapter 4, "Internal Control Structure" and footnote 7). In an audit of the financial statements of a governmental entity, this understanding includes knowledge about the design of internal control structure policies and procedures relevant to financial statement assertions affected by compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts and about whether those policies and procedures have been placed in operation. In planning the audit, such knowledge should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. The auditor's assessment of control risk for assertions affected by compliance with such laws and regulations may be influenced by policies and procedures in all three elements of the internal control structure (control environment, accounting system, and control procedures). For example, the following control environment factors may influence the auditor's assessment of control risk:

- a. Management's awareness or lack of awareness of applicable laws and regulations
- b. Entity policy regarding such matters as acceptable operating practices and codes of conduct
- c. Assignment of responsibility and delegation of authority to address matters such as organizational goals and objectives, operating functions, and regulatory requirements

**5.21** The auditor should consider whether any noted deficiencies in such internal control structure policies and procedures should be reported in accordance with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

## Other Laws and Regulations

**5.22** Governmental entities may be affected by many other laws or regulations, including those related to occupational safety and health, environmental protection, equal employment, and price-fixing. Generally, these laws and regulations concern an entity's operations more than financial reporting and accounting. Their effect on an entity's financial statements is indirect, and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. Otherwise, however, an auditor ordinarily would not have sufficient basis to recognize possible violations of these laws. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the entity, or there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.<sup>12</sup>

**5.23** If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of such illegal acts, an audit made in accordance with GAAS provides no assurance that indirect effect illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

## Working Paper Documentation

**5.24** The auditor should document procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339).<sup>13</sup> The auditor's understanding of the internal control structure as it pertains to com-

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<sup>12</sup> In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, SAS No. 54 notes that, where applicable, the auditor should also inquire of management concerning—

- The client's policies relative to the prevention of illegal acts.
- The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.

<sup>13</sup> The Audit Issues Task Force of the Auditing Standards Board has issued an interpretation of SAS No. 41 titled, "Providing Access to or Photocopies of Working Papers to a Regulator." The complete text of the interpretation was published in the July 1994 issue of the *Journal of Accountancy* and is also included in appendix K, herein.

pliance with such laws and regulations, as well as the related assessment of control risk, should be documented in accordance with SAS No. 55. See paragraphs 3.34 and 3.35 for discussion of the additional field work standard related to working papers required by *Government Auditing Standards*.

## Written Representations From Management

**5.25** SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires the auditor to obtain written representations from management as part of an audit conducted in accordance with GAAS. In audits to which this guide applies, auditors should consider obtaining additional representations from management acknowledging that management—

- a. Is responsible for the entity's compliance with the laws and regulations applicable to it.
- b. Has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts.
- c. Has identified and disclosed to the auditor violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

## Responsibilities Under *Government Auditing Standards*

**5.26** *Government Auditing Standards* prescribes additional field work standards beyond those required in an audit in accordance with GAAS on audit follow-up and working papers. See paragraphs 3.34 and 3.35 for further discussion of working paper requirements and paragraph 3.36 for further discussion of audit follow-up. Although *Government Auditing Standards* refers to the auditor's responsibilities with regard to noncompliance with provisions of contracts or grant agreements as an *additional* field work standard, auditors have this same responsibility under GAAS. See further discussion below.

**5.27** Noncompliance includes not only illegal acts, but also violations of provisions of contracts or grant agreements. Both *Government Auditing Standards* and GAAS require auditors to design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of laws, regulations, contracts, and grant agreements that have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible noncompliance with provisions of laws, regulations, contracts, or grant agreements that could have a material indirect effect on the financial statements, auditors should apply procedures specifically directed to ascertaining whether that noncompliance has occurred. When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that noncompliance has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

## Reporting Under *Government Auditing Standards*

**5.28** A governmental entity may engage an auditor to audit its financial statements in accordance with *Government Auditing Standards*. In performing such an audit, the auditor assumes responsibilities beyond those of an audit



conducted in accordance with GAAS to report on compliance with laws and regulations and on the internal control structure.<sup>[14]</sup> See paragraphs 4.14 and 4.15 for further discussion of responsibilities for reporting on the internal control structure.

## Reporting on Compliance With Applicable Laws and Regulations

**5.29** Paragraph 5.15 of *Government Auditing Standards* requires the auditor to report on compliance with laws and regulations. This report can be issued separately or in the report on the financial statements. Therefore, the report on the financial statements should either (1) describe the scope of the auditors' testing of compliance with laws and regulations and present the results of those tests or (2) refer to a separate report containing that information. In reporting on compliance with laws and regulations, auditors should report irregularities, illegal acts, and other material noncompliance (for example, a violation of a contract provision). When auditors report on compliance in the report on the financial statements, they should include an introduction summarizing key findings in the audit of the financial statements and the related compliance work. Auditors should not issue this summary as a stand-alone report.

**5.30** The auditor's report on compliance is based on the results of procedures performed as part of the audit of financial statements. Matters the auditor considers in reporting on compliance in accordance with *Government Auditing Standards* are as follows:

- a. Description of the scope of the auditor's testing of compliance (paragraph 5.32)
- b. Reporting irregularities and illegal acts (paragraphs 5.33 and 5.34)
- c. Reporting noncompliance (paragraphs 5.35 through 5.41)

**5.31** The basic elements of the auditor's report on compliance with laws and regulations are—

- a. A statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with GAAS and with *Government Auditing Standards* issued by the Comptroller General of the United States.
- c. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- d. A statement that management is responsible for compliance with laws, regulations, contracts, and grants.
- e. A statement that, as part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, the auditor performed tests of compliance with certain provisions of laws, regulations, contracts, and grants.
- f. A statement that the objective of the audit of the financial statements was not to provide an opinion on overall compliance with such provisions and a disclaimer of opinion on compliance with laws, regulations, contracts, and grants.

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<sup>[14]</sup> [Deleted.]

- g. A statement describing the results of the auditor's tests of compliance.
- h. If applicable, a statement that clearly inconsequential irregularities or illegal acts and immaterial other noncompliance (for example, a violation of a contract provision) were communicated to management in a separate letter.
- i. A statement that the report is intended for the information of the audit committee, management, and specific legislative and regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.
- j. The manual or printed signature of the auditor's firm.
- k. The date of the auditor's report.

## Scope of the Auditor's Work

**5.32** *Government Auditing Standards* requires that auditors report the scope of their testing of compliance with laws and regulations and present the results of those tests. If the tests performed did not exceed those the auditor considered necessary for a financial audit in accordance with *Government Auditing Standards*, then a statement that the auditors tested compliance with certain laws and regulations would be sufficient to satisfy this requirement. Auditors should also report whether or not the tests they performed provided sufficient evidence to support an opinion on compliance.

## Reporting on Irregularities or Illegal Acts

**5.33** *Government Auditing Standards* requires that when auditors conclude, based on evidence obtained, that an irregularity or illegal act either has occurred, or is likely to have occurred, they should report relevant information. Auditors need not report information about an irregularity or illegal act that is clearly inconsequential. Thus, auditors should present in a report the same irregularities and illegal acts that they report to audit committees under SAS No. 53 and SAS No. 54.

**5.34** Paragraphs 5.21 through 5.25 in chapter 5 of *Government Auditing Standards* provide the following guidance on direct reporting of irregularities and illegal acts:

*Government Auditing Standards* requires auditors to report irregularities or illegal acts directly to parties outside the auditee in two circumstances, as discussed below. These requirements are in addition to any legal requirements for direct reporting of irregularities or illegal acts. Auditors should meet these requirements even if they have resigned or been dismissed from the audit.

The auditee may be required by law or regulation to report certain irregularities or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such irregularities or illegal acts to the auditee, and it fails to report them, then the auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the irregularities or illegal acts directly to the external party specified in the law or regulation.

Management is responsible for taking timely and appropriate steps to remedy irregularities or illegal acts that auditors report to it. When an irregularity or illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to

take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statements or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the irregularity or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the irregularity or illegal act directly to that entity.

In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported irregularities or illegal acts. If they are unable to do so, then the auditors should report the irregularities or illegal acts directly as discussed above.

Chapter 4 [of *Government Auditing Standards*, paragraph 4.16] reminds auditors that under some circumstances, laws, regulations, or policies may require them to report promptly indications of certain types of irregularities or illegal acts to law enforcement or investigatory authorities. When auditors conclude that this type of irregularity or illegal act either has occurred or is likely to have occurred, they should ask those authorities and/or legal counsel if reporting certain information about that irregularity or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

## Reporting Noncompliance

**5.35** Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts, or grants, that cause the auditor to conclude that the aggregation of misstatements (that is, the auditor's best estimate of the total misstatement) resulting from those failures or violations is material to the financial statements. When the auditor's procedures disclose material instances of noncompliance, the auditor should modify his or her report on compliance to report relevant information. The report should include—

- a. An identification of material instances of noncompliance noted.<sup>15</sup>
- b. A statement that the noncompliance noted was considered in forming an opinion on whether the entity's financial statements are presented fairly, in all material respects, in conformity with GAAP.

**5.36** The auditor should report material instances of noncompliance regardless of whether the resulting misstatements have been corrected in the entity's financial statements. The auditor may wish to include a statement about whether the misstatements resulting from the material instances of noncompliance have been corrected in the financial statements or a statement describing the effect of such misstatements on his or her report on the basic financial statements. Illustrations of the auditor's report on compliance when there are material instances of noncompliance are presented in appendix A of this guide.

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<sup>15</sup> Paragraph 5.19 of *Government Auditing Standards* provides the following guidance on reporting material irregularities, illegal acts, or other noncompliance: "...auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. In presenting material irregularities, illegal acts, or other noncompliance, auditors should follow chapter 7's [of *Government Auditing Standards*] report contents standards for objectives, scope and methodology; audit results; views of responsible officials; and its report presentation standards, as appropriate."

**5.37** Paragraph 5.20 of *Government Auditing Standards* includes the following provisions for reporting on irregularities, illegal acts, or other non-compliance (see paragraphs 5.33 and 5.34 for further reporting guidance on irregularities and illegal acts):

When auditors detect irregularities, illegal acts, or other noncompliance that do not meet paragraph 5.18's [of *Government Auditing Standards*] criteria for reporting, they should communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they report on compliance. Auditors should document in their working papers all communications to the auditee about irregularities, illegal acts, and other noncompliance.

**5.38** If the auditor has issued a separate letter describing immaterial instances of noncompliance, the report on compliance prepared in accordance with the preceding paragraphs should be modified to include a statement such as the following: "We noted certain immaterial instances of noncompliance that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1."

**5.39** For audits in accordance with GAAS and *Government Auditing Standards*, the effects of any material violations or possible violations of laws or regulations identified as a result of the auditor's procedures should be considered for disclosure in the footnotes to the financial statements or as a basis for recording a loss contingency, as provided for in FASB Statement No. 5, *Accounting for Contingencies*. If disclosure is not made or a loss is not recorded, the auditor should consider modifying the audit report on the financial statements, for example, by giving a qualified opinion using "except for" wording. See SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), for guidance. The auditor's consideration of illegal acts is discussed further in paragraphs 5.22, 5.23, 5.33, and 5.34.

**5.40** When the auditor cannot examine evidence sufficient to determine whether compliance with applicable laws and regulations exists, and if the potential effect of noncompliance could be material, a scope limitation may exist and the auditor's report on the financial statements would be modified accordingly.

**5.41** There may be situations where the auditor has determined that the entity did not comply with an applicable law or regulation, but management is unable to make a reasonable estimate of the financial effect expected to result from the noncompliance. *Government Auditing Standards* requires a compliance report to be issued regardless of whether the financial effect of the noncompliance is fully known, and, accordingly, the standard report, as illustrated in example A.17(A) in appendix A, would be modified to reflect the results of the audit procedures (see example A.17(B) in appendix A for an illustration). The auditor should also consider the effect of the noncompliance on the general-purpose financial statements and modify the report on those statements as necessary in accordance with SAS No. 58, as amended by SAS No. 79.

## Responsibilities Under the Single Audit Act

**5.42** The Single Audit Act of 1984 and OMB Circular A-128, *Audits of State and Local Governments*, which the OMB issued to prescribe policies, pro-

cedures, and guidelines to implement the act, require state and local governments that receive total federal financial assistance equal to or in excess of \$100,000 in a fiscal year to have an audit performed in accordance with the Single Audit Act. They also require that recipients of between \$25,000 and \$99,999 of federal financial assistance have an audit in accordance with the Single Audit Act or the federal laws and regulations of the programs in which the government participates (see paragraphs 5.45 and 5.46 for a discussion on program specific audits).

**5.43** The auditor should test and report on the following matters pertaining to compliance with laws and regulations:

- a. Compliance with laws and regulations that may have a material effect on the financial statements
- b. Compliance with general requirements applicable to federal financial assistance
- c. Compliance with specific requirements that may have a material effect on each major program, as defined by the Single Audit Act
- d. Compliance with certain laws and regulations applicable to nonmajor federal financial assistance programs

**5.44** The auditor's responsibilities under the Single Audit Act with respect to testing and reporting on compliance with laws and regulations are discussed in Part VII, "Audits of Federal Financial Assistance."

## Other Compliance Auditing Responsibilities

### Program-Specific Audits

**5.45** Under certain circumstances, the Single Audit Act and OMB Circulars A-128 and A-133 permit certain recipients of federal financial assistance to have a program-specific audit. Entities not covered by the Single Audit Act or OMB Circular A-133 also may engage an auditor to conduct a program-specific audit in accordance with a federal audit guide (such as the U.S. Department of Education's *Student Financial Aid Audit Guide* or the U.S. Department of Housing and Urban Development's *Consolidated Audit Guide for Audits of HUD Programs*) or in accordance with an agreement from the grantor agency. When engaged to conduct a program-specific audit, the auditor should acquire an understanding of the audit requirements for that particular program from the agreement with the grantor agency, from an audit guide published by the grantor agency, or through contact with the grantor agency.

**5.46** The testing and reporting responsibilities of an engagement to conduct a program-specific audit will vary depending on the requirements of the grantor agency, which may differ from those addressed in this chapter. The guidance provided in this chapter should be applied to those engagements to the extent it is applicable to the specific program. Some federal audit guides may require an attestation engagement. In these cases, auditors should refer to Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500), for further guidance.

### State and Local Laws and Regulations

**5.47** An auditor also may be engaged to test and report on compliance with state and local laws and regulations other than those discussed in the preceding

paragraphs of this chapter. (Guidance for engagements related to management's written assertion about an entity's compliance with specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in SSAE No. 3.)

**5.48** In such cases, auditors should consider performing the following procedures:

- a.* Inquire of management about additional compliance auditing requirements applicable to the entity.
- b.* Inquire of the office of the state or local auditor or other appropriate audit oversight organization about audit requirements applicable to the entity.
- c.* Review information about governmental audit requirements available from state societies of certified public accountants or associations of governments.

**Part II**  
**The State and Local Government Audit—**  
**Governmental Funds and Account Groups**

## Chapter 6

# The Budget

### Introduction

**6.01** Budgeting is an essential element of the financial planning, control, and evaluation processes of governments. Almost all states currently require political subdivisions to adopt budgets for at least their general fund. Many states also require budgets to be adopted and reported for special revenue and debt service funds and, sometimes, for other funds of governmental units. The budgeting practices followed by governmental units vary greatly, and the auditor should be knowledgeable about the laws and regulations governing the budgetary requirements of the governmental unit being audited.

**6.02** GASB Cod. secs. 1700 and 2400 discuss the budget, budgetary accounting, and budgetary reporting. The basic statement of principle included in the Codification regarding budgeting and budgetary control asserts that—

- a. An annual budget(s) should be adopted by every governmental unit.
- b. The accounting system should provide the basis for appropriate budgetary control.
- c. A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports of each fund.

**6.03** In certain circumstances, a budget is not adopted because it is not legally required and, therefore, comparative budget and actual results cannot be presented. That situation should be disclosed in a note to the financial statements and the otherwise required financial statement omitted. The auditor's report on the financial statements is not affected. However, if a budget is legally adopted but budget and actual results are not presented, the auditor should express a qualified or adverse opinion because of a departure from GAAP. When adoption of a budget is legally required, presentation of budget and actual results is required by GAAP. Failure to present both budget and actual results in such circumstances is a departure from GAAP. Failure to adopt a budget when adoption of a budget is legally required is an illegal act. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), states that if the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.

**6.04** When conducting an audit of a state or local governmental unit, the auditor's understanding of the budget and the budgetary process is important. GASB Cod. sec. 2400 states that "Budgetary comparisons should be included in the appropriate financial statements and schedules for governmental funds for which an annual budget has been adopted." Thus, the auditor needs to understand the budget and the budget process in order to evaluate the appropriateness of budget information that is presented in the financial statements. When GAAP requires the presentation of budget information in the financial statements, the failure of a governmental unit to present appropriate budgets



may lead to inadequate financial statement disclosures that would require the auditor to modify his or her report on the financial statements. Knowledge of the budget process may also serve as a useful tool when performing analytical procedures during a governmental engagement. See paragraphs 6.26 through 6.28 for further information.

## Types of Budgets

**6.05** Governmental units may establish many different types of budgets, which may not be mutually exclusive. When one thinks of the term *budget*, one usually envisions a document developed to control revenues and expenditures for an operating period of one year. Expenditures may be controlled at the program, department, character, or object level of expenditure, as discussed later in this chapter. However, governmental units may develop a number of other budgets for various purposes and periods. Budgets also may be developed to measure service rather than monetary levels. Following are examples of other budgets that may be prepared by governmental units.

### Capital Budgets

**6.06** Capital budgets usually present estimates of revenues and expenditures for a period of several years—usually four to six—and the proposed means of financing capital outlays. They are planning documents that typically emphasize major program or capital outlay plans. Capital budgets should be updated periodically as priorities change and/or unanticipated projects come up. In conjunction with the preparation of capital budgets and the related sources of financing, the governmental unit also can anticipate future changes in allowable debt levels and annual debt service requirements.

### Proprietary Fund Flexible Budgets

**6.07** The nature of most operations financed and accounted for through proprietary funds is such that the demand for the goods and services provided largely determines the appropriate level of revenues and expenses. Increased demand for the goods or services causes a higher level of expense to be incurred, but also results in a higher level of revenues. Thus, as in commercial accounting, flexible budgets—prepared for several levels of possible activity—typically are better for proprietary fund planning, control, and evaluation purposes than are fixed budgets. Ideally, the basis on which the budget is prepared should be consistent with the basis of accounting used.

**6.08** When formally adopted, the expense estimates of flexible budgets typically are not viewed as appropriations but as approved plans. Budgetary control and evaluation are effected by comparing actual interim or annual revenues and expenses with planned revenues and expenses at the actual level of activity for the period. In some instances, local legal requirements may require a budget to be adopted for proprietary funds.

### Performance Budgets

**6.09** Performance budgets cover programs but they emphasize output, units of work performed, or services rendered within each program, such as tons of waste collected in the rubbish disposal program. Performance budgets relate the input of resources to the output of services.

## Budgetary Comparisons Included in Financial Statements

**6.10** A combined statement of revenues, expenditures, and changes in fund balances—budget and actual, general and special revenue fund types (and similar governmental fund types of the primary government for which annual budgets have been legally adopted)—is required to be presented as part of the GPFS, GASB Cod. sec. 2400.102.

**6.11** The minimum budget-basis presentation within the GPFS of a reporting entity is the aggregation by governmental fund type of the annual appropriated budgets for those funds, as amended, compared with related actual amounts. The annual appropriated budgets are those adopted by either the legislative or governing board of the primary government (and its component units that have been blended and are, as a result, reported with the primary government). Budgetary data for discretely presented component units are not required to be presented in the reporting entity's combined statement of revenues, expenditures, and changes in fund balance—budget and actual. (See GASB Cod. sec. 2400.103.)

## Auditor's Responsibility for Budgetary Information

**6.12** The basis on which a budget is prepared frequently is determined by state or local statutes, charters, or ordinances. When the budget has been prepared on a basis other than GAAP (for example, on a cash basis), the actual results reported on a GAAP basis should be restated to the same basis used in preparing the budget when preparing the actual and budget statement. The financial statements, or notes thereto, are required to provide a reconciliation of the actual results reported on a GAAP basis to the results reported on a budgetary basis.

**6.13** Many governmental units approve amendments to the original budget during the year. The comparison of actual results to budgeted results included in the GPFS should include all approved budget amendments in the budgeted numbers reported.

**6.14** Auditing standards do not provide for any difference in the level of audit assurance on the budgeted results reported versus the actual results reported. The auditor's procedures related to the budgetary information presented may be limited to determining the following:

- Which methods were used to assemble the original budget.
- That amendments were properly approved during the year.
- That the budget reflects all approved amendments.
- That applicable state and local statutes have been followed when adopting the budget and in approving subsequent amendments.

## Budgetary Compliance With Laws and Regulations

**6.15** SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), provides that the auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in the financial statements in all audits of governmental units conducted in accordance with GAAS. A legally adopted budget—which may take many forms, ranging from a single document that identifies all revenue sources and expenditures to num-

erous revenue and appropriation bills or ordinances—is the legal authority for the levy of taxes and the expenditure of monies. The auditor performs procedures to obtain an understanding of the laws governing the budgetary process and to determine whether budgets have been prepared and adopted in compliance with applicable laws and regulations. Those procedures may include, but are not limited to—

- Discussing with management and/or legal counsel the applicable statutes and ordinances governing the legal status of the budget and its applicability to the various funds of the governmental unit.
- Determining the level of budgetary control—that is, object, department, program, or fund, and the adequacy of the accounting system to operate at that level of control.
- Determining the basis of accounting on which the budget is prepared.
- Considering whether the budgetary process was performed in accordance with statutes and ordinances, including required public notifications and hearings.
- Reviewing the adopted budget for proper approval.
- Considering whether changes to the budget during the audit period were approved in accordance with applicable local and state laws.
- Evaluating whether material expenditures over appropriations in individual funds are disclosed.

## Level of Budgetary Control

**6.16** The auditor evaluates the effect on the financial statements (that is, the need for additional financial statement disclosures) of noncompliance with laws and regulations governing expenditures in excess of budgetary appropriations based on the legal level at which budgetary control is exercised. As stated in GASB Cod. sec. 2300.106, any excess of expenditures over appropriations in individual funds is to be disclosed in the notes to the GPFS. Budgetary control is commonly exercised at one of the following levels within the fund.

**6.17 *Program Function Level.*** A program budget emphasizes the cost of specific programs of governmental services without regard to the number of departments or divisions that may be involved in providing the services. Objectives are established for each program and costs to accomplish the objectives are estimated. The advantage of a program budget is that it considers the aggregate cost of individual programs. A disadvantage is that it is sometimes difficult to impose accountability on individual departments, divisions, or agencies.

**6.18 *Organizational Unit or Departmental Level.*** Budgeting by departmental unit promotes responsibility accounting. This classification corresponds with the governmental unit's organization structure. A particular department may be charged with carrying out one or several activities or programs.

**6.19 *Character Level.*** In addition to program or departmental budgets, expenditures may be further classified by character, that is, on the basis of the fiscal period they are presumed to benefit. The major character classifications of expenditures are *current expenditures*, which benefit the current fiscal period; *capital outlays*, which are presumed to benefit both the present and future fiscal periods; and *debt service*, which is presumed to benefit prior fiscal periods as well as current and future periods. *Intergovernmental*, a fourth

character classification, is appropriate where one governmental unit transfers resources to another, such as when states transfer *shared revenues* to local governments or act as intermediaries in federally financed programs. (See GASB Cod. sec. 1800.120.)

**6.20 Object Level.** Expenditures may be classified by object classes, that is, according to the types of items purchased or services obtained. Examples of *current operating* objects of expenditure classifications are personal services, supplies, and other services and charges. *Capital outlays*, *intergovernmental*, and *debt service* also are major objects-of-expenditure classifications.

**6.21** In most governmental organizations, compliance with legal budgetary requirements is usually monitored at either the program or department level, although other levels may be used in some governmental units. The governmental unit also may monitor expenditures at the character or object level, but this is done usually for managing expenditures rather than as a legal requirement. For example, a governmental unit may monitor expenditures for a given department at the departmental level. The fact that salary costs of that department may exceed budget, but that outside services are less than budget, may be useful for management purposes. However, as long as that department's expenditures, in total, are less than the budgeted level, noncompliance with legal budgetary laws and regulations may not exist. In instances where the governmental unit was legally required to monitor expenditures at the object level, a given department's salaries exceeding the budget may represent noncompliance with budgetary laws and regulations even though the department, in total, spent less than the amount budgeted.

## Encumbrances

**6.22** A final component of budgetary accounting, which is characteristic of governmental units, is encumbrance accounting, especially in general and special revenue funds. Encumbrances represent formal commitments (usually contracts or purchase orders) to acquire goods or services not yet received. They may be recorded in the accounts to ensure that expenditures do not exceed appropriations. Encumbrances outstanding at year end do not represent expenditures in accordance with GAAP. However, they may represent a portion of the fund balance that should be reserved for commitments made during the year.

**6.23** Some state laws may require encumbrances outstanding at year end to be considered as expenditures to be charged against current year appropriations. In these cases, encumbrances will be included with the expenditures reported on the budget and actual comparison statements. Outstanding encumbrances at the beginning and end of the year would be used to reconcile expenditures reported on the combined statement of revenues and expenditures with expenditures reported on the budget and actual budgetary-basis financial statement. The method by which encumbrances are accounted for and reported should be consistently applied and disclosed in the summary of significant accounting policies. (See GASB Cod. sec. 1700.130.)

## Audit Considerations

**6.24** The auditor's understanding of a governmental unit's practices in developing a budget and controlling operations through the budget may be a

significant component of the auditor's understanding of the control environment of a governmental unit.

**6.25** In documenting the understanding of the policies and procedures a governmental unit uses to develop and implement the budget, the auditor considers control policies and procedures that may be in place to ensure that expenditures have been properly approved, monitored, and classified within the accounts. If the auditor determines that these controls have been placed in service and are functioning properly, the auditor may assess control risk at less than the maximum and use the budget as a basis for reducing some substantive tests that otherwise may be necessary.

**6.26** Under SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), the auditor performs analytical procedures in both the planning and overall review phases of all audit engagements. An analytical procedure that compares actual results to budgeted results may be useful during the planning phase of the audit. However, the auditor must consider the effectiveness of the client's approach to budgeting and its philosophy regarding amendments to the budget, as well as the effectiveness of the client's controls over proper recording and classification of expenditures.

**6.27** Some governments adopt a budget after a thorough and thoughtful process and then use it to control operations. Other governments adopt a preliminary budget and amend it frequently, essentially allowing the budget to follow the results of operations. In the latter situation, comparing actual results to either the original or amended budgets may not be very useful. And, whether subsequently amended or not, if the original budget was not intended to be an operating guide, comparing actual results to the original budget may not be useful.

**6.28** On the other hand, when amending the budget, management of the governmental unit already may have investigated adequately and approved the variances of current results compared with the original budget. Therefore, the auditor may conclude that no further investigation is needed and that comparisons of actual results against amended budgeted results may identify adequately variances otherwise requiring additional investigation by the auditor.

## Management Representations

**6.29** As part of obtaining representations from management at the conclusion of the audit, the auditor may want to obtain specific representations, such as the following, about the budgetary process from management in the management representation letter.

- Applicable laws and regulations have been followed in adopting the budget.
- Approved budget amendments have been incorporated into the budget information included in the financial statements.
- Applicable laws and regulations have been followed in approving amendments to the original budget.

**6.30** Even though the auditor's responsibilities for the budget information included in the GPFS are limited to those described above, the auditor may become aware, during the course of the audit, of inappropriate budgeting techniques or estimates. With declining federal and state support of local government operations, declining tax bases, and other economic factors, governmental units sometimes utilize unique budgetary practices that may be in-

appropriate or unachievable. Even though not required by professional standards (unless the techniques or estimates represent errors, irregularities, or illegal acts), the auditor may want to communicate his or her findings or concerns to appropriate levels of management within the governmental entity.

## Chapter 7

# Cash and Investments

### Introduction

**7.01** Although the cash and investment transactions of governmental units are similar to those of business enterprises, they differ in several significant ways. These differences include the nature of transactions, accounting and compliance, financial statement presentation and disclosure, internal control structure and auditing considerations.

**7.02** GASB Cod. secs. C20, I50, R10, and Pe5 provide guidance on the accounting and financial statement presentation and disclosure requirements for cash and investment transactions. Additional guidance is provided in a GASB staff document, *Questions and Answers Guide to Implementation of GASB Statement No. 3 on Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*.

### Nature of Transactions

#### Decentralization

**7.03** Cash is collected by governments to support a variety of functions and is often collected at a number of locations, such as tax collection departments for income, sales, or property taxes; billing departments for services rendered; courts for fines or judgments; and recreational facilities for user fees. In some cases, the decentralization of cash collections results when elected tax collectors function entirely separately from other finance or organizational departments of the governmental unit. Collections generally include many small receipts, as well. Because all cash collections may not be under the direct control of a centralized treasury, internal control procedures related to receiving, depositing, and recording cash may increase control risk.

#### Check Truncation

**7.04** Because the Uniform Commercial Code (UCC S-406(I)) provides that a bank is under no obligation to return canceled checks to a customer if it makes such checks available to customers in “a reasonable manner,” many banks have developed the practice of not returning canceled checks, called check truncation. The management of a governmental unit is responsible for maintaining sufficient internal controls to compensate for the absence of returned canceled checks. If state laws or agreements for intergovernmental financial assistance programs provide that the governmental unit is responsible for maintaining records that include canceled checks, the auditor should consider whether the absence of canceled checks constitutes noncompliance.

### Accounting, Auditing, and Compliance Considerations

**7.05** The audit of cash and investment transactions of governmental units is also affected by certain other factors, such as the pooling of cash and investments from all funds, state and local restrictions on the type of deposits or investments permitted, and the requirement for obtaining collateral and complying with arbitrage rules.

## Pooling of Cash and Investments

**7.06** Governmental units commonly pool both the cash and the investments of all funds for reasons of physical custody and control, enhanced investment opportunities, or operating efficiency. Pooling cash or investment activities may simplify collection, custody, and disbursement. In some cases, however, pooling cash and investments is prohibited by state or local laws or by clauses in contractual or debt-financing agreements. For example, a bond indenture may prohibit pooling the cash in a sinking fund with that of other funds.

**7.07** When governmental units pool the cash accounts of several funds, each fund has an interest in the pooled account. When one fund overdraws its share of the pooled account, that fund should report an interfund liability to the fund that the management of the governmental unit deems to have loaned the cash or investments to the overdrawn fund. The fund deemed to have loaned the cash or investments should report an interfund receivable from the borrowing fund. This treatment is unaffected by whether the loaning and borrowing funds are of the same or different fund types. If the pooled cash account for the governmental unit is overdrawn in total, the balance should be classified as a fund liability.

**7.08** Pooled cash accounts or investments within a governmental unit may also require an analysis of the reasonableness of management's allocation of investment earnings to the funds participating in the pool. Such earnings are sometimes allocated by legislative action. However, interest earned on federal program money received must be credited to each individual program, even though the money often is included in a pooled cash or investment fund.

**7.09** A governmental unit may also enter into an agreement to undertake cooperatively the investment of its money with another government or with a private entity such as a mutual fund. Many states operate investment pools for the benefit of their local governments. Such an agreement may authorize a single investment transaction or provide for the pooling and investment of idle funds on an ongoing basis. This type of agreement should include provisions for the types of investments that are permissible; the procedures for making each type of investment; whether the investments will be held in the name of a single participant or all the participants; the manner in which income, losses, and expenses will be shared; and the circumstances under which each participant may redeem or liquidate its interest therein.

## State and Local Restrictions

**7.10** State statutes or local ordinances usually limit the types of deposits and investments governmental units may acquire. GASB Cod. sec. I50, paragraphs .102 through .158, addresses the nature and types of deposits with financial institutions and investments and the risks associated with them. Expenditure of cash or the use of investments may be restricted by contractual agreements or legal requirements. For example, bond proceeds may be restricted for expenditure on a specific capital project.

## Repurchase and Reverse Repurchase Agreements

**7.11** A repurchase agreement is a hybrid transaction that has features of both a purchase and sale, and a secured loan. The characterization of a repurchase agreement as a purchase and sale is important to governments because many are prohibited from lending assets to private organizations. This



prohibition may extend to lending cash and investments in the form of repurchase or reverse repurchase agreements. Often, a government will enter into a repurchase agreement providing for the purchase of specific securities matched simultaneously with an agreement to sell back those same securities to the third party at an increased price, which produces an economic gain that is accounted for as interest earnings. Other types of repurchase agreements, as well as related accounting and financial reporting guidance, are discussed further in GASB Cod. sec. I50. Governments may enter into a master repurchase agreement to clarify the intent and rights of the parties to the transaction. A reverse repurchase agreement occurs when the government has sold securities and entered into an agreement to repurchase them at some future date. This type of agreement presents both market and credit risk to the government. Auditors should note that the GASB has issued GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements*, which clarifies the reporting requirements for reverse repurchase and fixed-coupon reverse repurchase agreements and is effective for financial statements for periods beginning after December 15, 1995, with early application encouraged. Also, in a related area, GASB Statement No. 28, *Accounting and Reporting for Securities Lending Transactions*, establishes accounting and reporting for securities lending transactions and is effective for periods beginning after December 15, 1995, with early application encouraged. Securities lending transactions are transactions in which governmental entities transfer their securities to broker-dealers and other entities for collateral—which may be cash, securities, or letters of credit—and simultaneously agree to return the collateral for the same securities in the future.

## Collateralization

**7.12** Some state statutes or local ordinances require collateralization of cash deposits by the depository institutions when they exceed the amount of any depository insurance. The purpose of designated collateral is to provide protection for deposits of the state or political subdivision. A governmental unit may require the depository institution to pledge specified types of securities as collateral equal to, for example, 100 percent to 110 percent, of the uninsured deposits. The statute or ordinance often specifies the type, ratio, or dollar amount of collateral required when the deposits exceed depository insurance. GASB Cod. secs. C20 and I50 provide a discussion on secured bank balances, collateralized or uncollateralized (see also GASB staff document, *Questions and Answers Guide to Implementation of GASB Statement No. 3*).

## Arbitrage

**7.13** Arbitrage earnings result when proceeds of debt issues are invested in securities paying a higher rate of interest than that which is incurred on the debt issue. As discussed in chapter 11, “Debt and Debt Service,” some governmental units issuing tax-exempt bonds are required to comply with Internal Revenue Service (IRS) arbitrage rules for rebating to the federal government excess earnings from investment of bond proceeds.

## Financial Statement Presentation and Disclosure

**7.14** Cash and investment balances are segregated into individual funds and presented in the financial statements of governments in a manner similar to those of business enterprises. It is sometimes necessary to classify certain

cash and investments as restricted assets to comply with legal or contractual requirements (that is, revenue bond proceeds, reserve funds). In addition, the following specific GASB requirements require consideration:

- *Cash and Cash Equivalents.* On the combined balance sheet, one line is usually used to show the cash position amounts for each fund type and discretely presented component unit entities. GASB Cod. sec. 2450 requires a statement of cash flows for all proprietary and nonexpendable trust funds and component unit entities using proprietary fund accounting. Cash equivalents generally include all investments with original maturities of three months or less from the date of purchase. GASB Cod. sec. 2450.105 states that the total amounts of cash and cash equivalents at the beginning and the end of the period in the statement of cash flows should be easily traceable to similarly titled items or subtotals shown in the statements of financial position as of those dates. See GASB Cod. sec. 2450.106 for a definition of cash and cash equivalents.
- *Cash Deposits With Financial Institutions, and Investments, Including Repurchase Agreements.* GASB Cod. secs. C20, I50, and R10 require certain disclosures about deposits with financial institutions, investments, and accounting and financial reporting guidance for repurchase agreements and reverse repurchase agreements. Also, the GASB has issued GASB Interpretation No. 3 which clarifies the reporting requirements for reverse repurchase and fixed-coupon reverse repurchase agreements and is effective for financial statements for periods beginning after December 15, 1995, with early application encouraged. Disclosures for cash and investments normally include the types of investments authorized by legal or contractual provisions, descriptions of the nature and extent of any restrictions or commitments, the valuation basis of investments, market value, and the degree of credit risk.
- *Derivatives and Similar Investment Transactions.* GASB Technical Bulletin No. 94-1, *Disclosures About Derivatives and Similar Debt and Investment Transactions*, requires certain disclosures about derivatives and similar investment transactions.

**7.15** Investments reported in governmental funds generally are valued at cost. Valuation guidance for pension trust funds is provided in GASB Cod. sec. Pe5 (see paragraph 14.12 for guidance for deferred compensation plans). Auditors should consider whether unrealized losses are properly recorded due to decreases in market value when the market decline is not due to a temporary condition. The liquidity needs of the governmental unit may require sales of investments at losses subsequent to the balance-sheet date. In such circumstances, auditors should consider whether this represents objective evidence of a permanent decline that should be recognized in the current financial statements.

## Assertions

**7.16** The categories of financial statement assertions and the specific audit objectives applicable for cash and investments are related as follows:

- *Existence or Occurrence.* Cash and investments in the combined balance sheet are on hand, in transit, on deposit with third parties (depositories) in the name of the governmental unit, or are held by a third party (trust or custodian agent) on behalf of the governmental unit.

- *Completeness.* All cash and investment balances of the governmental unit are reported.
- *Rights and Obligations.* Depositories and investment counterparties are legally acceptable. If law requires depository institutions to maintain specified collateral, such collateral is adequate. Investments are of types authorized by law and the investment policy of the governmental unit.
- *Valuation or Allocation.* Cash and investment balances reflect a proper cutoff of receipts and disbursements and are reported at the proper amount. Income gains or losses are allocated to the appropriate funds.
- *Presentation and Disclosure.* Cash and cash equivalents, investments, and restricted cash and investments are reported separately by fund type. Related disclosures are adequate, and balances are fairly stated on a basis consistent with that of the preceding year.

## Internal Control Structure and Auditing Considerations

**7.17** The portion of appendix B, “Illustrative Internal Control Structure Questions—State and Local Governmental Units,” that relates to cash and investments may be considered by the auditor in performing a risk assessment.

**7.18** The auditor should obtain an understanding of the internal controls over cash and investments. This understanding should consider the nature of all significant types of investment transactions, especially repurchase and reverse repurchase agreements, so that appropriate audit procedures may be assigned to each type of investment. The auditors should also consider the various types of risks involved, including business risk, market risk, credit risk, and risk of collateral loss, as well as the steps taken by the governmental unit to control those risks. Guidance on evaluating risks is provided in the AICPA Audit and Accounting Guide *Audits of Savings Institutions* and the AICPA’s *Report of the Special Task Force on Audits of Repurchase Securities Transactions*.

**7.19** Highly decentralized cash collection procedures potentially increase inherent and control risks. The auditor should consider the internal control structure over collection procedures at each of the various cash collection locations. Each location should have adequate segregation of duties to provide reasonable assurance of the completeness and accuracy of recorded cash transactions and balances.

**7.20** The internal control structure should provide reasonable assurance of compliance with laws and regulations governing the collection deposit and investment of cash. Controls should exist to provide reasonable assurance of proper segregation of cash and investments and of allocations of related earnings, gains, or losses among the various funds of the governmental unit.

**7.21** The auditor should consider the controls designed to prevent improper interfund borrowings, and to prevent or detect unrecorded cash receipts, especially from fines and other sources of revenue of a high volume of individual, small, cash receipts.

**7.22** There are related activities, such as recreational or school activity funds, that may be part of the reporting entity under GASB Cod. sec. 2100. Cash shortages incurred through those activities may result in liabilities of the governmental unit.

## Audit Procedures

**7.23** In planning the audit of cash and investments, it is usually efficient and effective to apply the audit procedures for all funds of the entity, as a whole, rather than by fund type or by individual fund. These procedures include determining that the governmental unit's cash records agree with depositories' records by reviewing bank reconciliations and, in some cases, cut off bank statements obtained directly from the bank.

**7.24** The cash and investment balances may be confirmed with banks or other depositories as of the balance-sheet date using the *AICPA Standard Form to Confirm Account Balance Information With Financial Institutions*. This confirmation form is limited to corroboration of information supplied by the governmental unit to the auditor (for example, deposit and loan balances). It is not designed to obtain information that the governmental unit would not ordinarily disclose (for example, contingent liabilities, security agreements). A separate request is sent to the governmental unit's account manager at the bank or other depository to elicit information on matters such as contingent liabilities. Investment balances with entities other than depositories should be confirmed directly.

**7.25** In addition, the auditor should consider performing procedures, as appropriate, relative to—

- Whether controls have been established and are in place over all activities and locations receiving, maintaining, and expending cash and investments.
- Whether there is compliance with legal or official authority for all depositories and investments.
- Whether interfund cash and investment transactions have been properly identified, classified, approved, and reported.
- Whether there is compliance with laws, regulations, and investment policies governing the deposit, investment, and collateralization of public funds.
- The adequacy of collateral.
- The appropriateness of the allocation of earnings and gains or losses from pooled cash and investments to individual funds.
- Whether the liquidity requirements of the governmental unit will require sales of investments at a loss, which should be reported currently in the financial statements.

## Chapter 8

# Receivables and Revenues

### Introduction

**8.01** Receivable and revenue transactions in governmental funds are closely related, and many audit procedures apply to both of them. Evidence supporting assertions in the balance sheet about receivables also supports assertions about revenues in the statement of revenues, expenditures, and changes in fund balance.

### Nature of Transactions

**8.02** In governmental funds, receivables usually arise as a result of revenue transactions. Governmental funds receive revenues from a variety of sources, including intergovernmental grants; taxes; and licenses and permits; and charges and fees collected in return for services. Interfund receivables may also be generated by the transfer or advance of resources between funds.

**8.03** Governmental units sometimes provide capital improvements or services to benefit a particular group of property owners rather than the general citizenry by creating special assessment districts, providing or arranging financing, and billing and collecting the assessments. Revenues and expenditures for service-type special assessments are reported in a general, special revenue, or enterprise fund, as appropriate. Revenues and expenditures for capital-type special assessments are usually reported in a capital projects, debt service, or enterprise fund, as appropriate. See GASB Cod. sec. S40.

### Accounting and Auditing Considerations

#### General Principles

**8.04** According to GASB Cod. sec. 1600.106, revenues are recognized in the accounting period in which they become susceptible to accrual, that is, when they become both measurable and available (in this context *accrual* refers to the modified accrual basis of accounting). The term *available* generally means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period. *Measurable* refers to the ability to quantify in monetary terms the amount of the revenue and receivable. GASB Cod. sec. 1600.126 states that transfers of financial resources among funds should be recognized in all funds affected in the period in which the interfund receivable(s) and payable(s) arise. Chapter 12, "Interfund Transactions and Fund Equity," describes the various types of interfund transactions.

#### Receivables

**8.05 *Revenue-Related Receivables.*** GASB Cod. sec. 1600.107 through 1600.116 states that governmental fund revenues that usually can and should be recognized on the accrual (in this context, the modified accrual) basis, include property taxes, regularly billed charges for inspection or other routinely provided services, most entitlement and unrestricted financial assistance grants from other governments, and taxpayer-assessed taxes such as sales and income taxes. The property taxes due a government, net of estimated uncollectibles, typically can be determined and recorded in the accounts when levied. Deferred

revenues, other than those arising from grants, are recorded when receivables are deemed to be measurable even though they are not available.

**8.06 *Intergovernmental Financial Assistance.*** Recognition of revenue from grants, entitlements, or shared revenues is described in GASB Cod. sec. G60.109. Generally, entitlements and shared revenues are recognized as revenue when received or earlier, if measurable and available. Resources arising from grants are usually subject to restrictions. Therefore, most grant revenues are recognized as revenue only when the conditions of the grant are met. Grant funds received before eligible costs are incurred, including cost-sharing or matching requirements, are recorded as deferred revenue. Eligible grant-related expenditures or expenses incurred in the advance of cash receipts result in recording the related receivables and revenue. GASB Statement No. 24, *Accounting and Reporting for Certain Grants and Other Financial Assistance* (effective for financial statements for periods beginning after June 15, 1995), establishes accounting and financial reporting standards for pass-through grants, food stamps, and on-behalf payments for fringe benefits and salaries.

**8.07 *Interfund Transaction-Related Receivables.*** Receivables are also created by loans or advances to other funds of the governmental unit, the generation of revenues in quasi-external transactions (such as payments in lieu of taxes due from an enterprise fund), and reimbursements due from other funds not received at the reporting date. Interfund transactions are described further in chapter 12. The assessment of collectibility of interfund receivables is the same as for any other receivable. If the receivable is not deemed collectible, in whole or in part, it should be written off or written down to net realizable value, and the transaction classified as an operating transfer or a residual equity transfer by each fund, depending on the substance of the original transaction.

## Revenues

**8.08** Some revenues are recognized when received in cash and, consequently, no receivable is recorded. Other revenues are accrued and related receivables are established. The following discussion describes the accounting and financial reporting practices applicable to several common sources of revenues for governments.

**8.09 *Taxes.*** Taxes are the major source of revenue for most governments. Recognition of tax revenue varies according to the type of tax because different types of taxes become measurable and available at different times.

**8.10 *Property Taxes.*** Property taxes are ordinarily considered available if they are levied and due before year end and collected within sixty days following the end of the year. Because of unusual circumstances, if the facts justify a period greater than sixty days, the governmental unit should disclose the period being used and the facts justifying that revenue recognition policy. Recognition of property tax revenue is described in GASB Cod. sec. P70.

**8.11 *Sales Taxes.*** GASB Statement No. 22, *Accounting for Taxpayer-Assessed Tax Revenues in Governmental Funds*, requires that revenues from taxpayer-assessed taxes, such as sales taxes, net of estimated refunds, should be recognized in the accounting period in which they become susceptible to accrual—that is, when they become both *measurable* and *available* to finance expenditures of the fiscal period. Sales taxes collected by merchants but not yet required to be remitted to the taxing authority at the end of the fiscal year and taxes collected and held by one government agency for another should be accrued if they are to be remitted in time to be used as a resource for payment of obligations incurred during the preceding fiscal year.

**8.12 *Income Taxes.*** Many governments raise revenues through income taxes levied on wages, net income as defined by the taxing authority, or other transactions. GASB Statement No. 22 requires revenue from taxpayer-assessed taxes, such as income taxes, net of estimated refunds, to be recognized in governmental funds in the accounting period in which they become susceptible to accrual—that is, when they become both measurable and available to finance expenditures of the fiscal period.

**8.13 *Licenses, Permits, and Other Similar Fees.*** Revenues from licenses, permits, and other similar fees usually are recorded when cash is received.

**8.14 *Services Financed by Special Assessments.*** Service-type special assessments do not result in the construction of assets and generally are not associated with the issuance of long-term debt. Service-type assessments often are established in response to limitations on property tax rates where basic services or additional services are provided to property owners on an assessment basis. The type of services provided under these arrangements include streetlighting and streetcleaning, weed cutting, and snow removal.

**8.15** GASB Cod. sec. S40.114 states that revenues for service-type special assessments are recognized in a manner similar to that used for user fees. Both the assessment revenues and the expenditures (expenses) for which the assessments were levied should be recognized on the same basis of accounting as that used for the fund type in which the service-type special assessments are recorded. For governmental funds, recognition should occur when the revenues are measurable and available, that is, revenue should only be recognized in the amount of annual assessment installments as they become due and are billed to property owners. Any noncurrent installments should be recorded as deferred revenue in the governmental funds.

**8.16** Receivables of all funds should be evaluated as to collectibility and, if necessary, allowances for estimated uncollectible amounts should be recorded.

## Financial Statement Presentation and Disclosure

**8.17** The summary of significant accounting policies should describe the accounting principles used for recognizing all material revenues. The description of the property tax revenue recognition policy should follow the guidance contained in GASB Cod. sec. P70. If intergovernmental grant revenues are subject to adjustment as, for example, when significant questioned costs may be identified in a grant compliance audit, the auditor should consider whether a loss contingency exists and, if so, whether a liability should be recorded or additional disclosure is required.

**8.18** The amount of interfund receivables and payables, by fund, reported in the financial statements is a required disclosure, which generally is presented in a footnote. (See GASB Cod. sec. 2300.106 and chapter 12.)

## Assertions

**8.19** The categories of financial statement assertions and the specific audit objectives applicable for receivables and revenue are related as follows:

- *Existence or Occurrence.* Only revenues that are measurable and available in the fiscal period are recorded, and receivables representing amounts uncollected at the end of the period are valid.

- *Completeness.* Revenues that are available and measurable in the fiscal period and all receivables are recorded; some receivables may not result from revenue transactions.
- *Rights and Obligations.* The governmental unit has satisfied the relevant legal requirements to receive all revenues and receivables recorded.
- *Valuation or Allocation.* Revenues are billed or charged and recorded at the correct amount, and receivables are stated at the net realizable amount.
- *Presentation and Disclosure.* Revenues, receivables, and deferred revenues are properly classified by fund type in the financial statements, and related disclosures are made.

## Internal Control Structure and Auditing Considerations

**8.20** The auditor determines the governmental unit's various revenue sources by reading legal documents, such as budgets, enabling legislation, and grant agreements; inquiring of responsible officials concerning sources of revenue; and reviewing the financial statements of the prior period. When the sources and amounts of anticipated revenues are identified, the auditor obtains a more detailed understanding of the internal control structure of the processes for billing, collection, and receipt for the major revenue sources.

**8.21** The portion of appendix B, "Illustrative Internal Control Structure Questions—State and Local Governmental Units," that relates to revenues and receivables may be considered by the auditor in performing a risk assessment.

**8.22** Additional internal control structure features related to specific sources of revenues and receivables include the following for property taxes:

- Periodic comparison of tax assessment rolls to real estate property files for completeness and proper jurisdictional boundaries
- Periodic redetermination of property assessments
- Annual reconciliation of the current year's roll to the prior year's roll
- Prompt updating of assessor's records for transfers of property
- Separation of the tax collection function from all other financial functions
- Establishment of and compliance with specific written procedures for abatements, exonerations, and refunds
- Vesting of authority to abate interest and penalties in an individual, independent of the tax collection function
- Totaling and comparing individual tax bills to total tax levy before mailing
- Agreeing recorded tax billings to total tax levy
- Establishment of appropriate billing, collection, and revenue recognition procedures for properties subject to payments in lieu of taxes
- Appropriate legal procedures for liens, tax sales, and foreclosures
- Authorization for disposal of parcels due to nonpayment of taxes, independent of the tax collection function

Internal control structure features related to sales, income, and other similar taxes, and intergovernmental revenues include—

- Maintaining a file of taxpayers, licensees, or permit holders and periodic and routine comparison of filed returns to the file to ensure that taxpayers are filing currently and with the appropriate jurisdiction.



- Conducting audits of tax returns on a scheduled basis.
- Establishing controls to assure that the compliance features of grants are monitored.

## Audit Procedures

**8.23** Account receivable balances are often small. Therefore, the audit approach to receivables in a governmental unit is often integrated with the substantiation of revenues. This audit approach frequently is the reverse of that of a business enterprise where substantiation of revenues is often a by-product of the audit of receivables.

**8.24** Audit procedures are designed to achieve audit objectives and assure compliance with legal requirements, such as grant agreements, ordinances, and statutes. The auditor should consider the procedures outlined in the sections that follow when developing a plan for the audit of receivables and revenues.

## Confirmations

**8.25** Many receivables and revenues are susceptible to confirmation. Confirmation of receivables provides evidence about the existence and ownership of a receivable but provides little evidence about collectibility. Collectibility usually is evaluated through the examination of subsequent receipts and historical trends. In SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), see paragraphs 17 through 22, "Form of Confirmation Request" (AICPA, *Professional Standards*, vol. 1, AU sec. 330.17 through .22) and paragraphs 34 and 35, "Confirmation of Accounts Receivable" (AICPA, *Professional Standards*, vol. 1, AU sec. 330.34 and .35) for further guidance. In some cases, audit evidence is obtained more readily through the application of alternative audit procedures. However, if the confirmation of receivables is not performed due to the existence of one of the three conditions noted in paragraph 34 of SAS No. 67, the auditor must document how he or she overcame the presumption that receivables would be confirmed.

**8.26** For intergovernmental grant revenue and tax revenue collected by other governmental units, the auditor may confirm the amounts transmitted to the governmental unit being audited during the fiscal period as well as the unremitted amounts to be recorded as receivables.

**8.27** Normally, the confirmation of balances owed by individual taxpayers is not effective when the receivable balance for property taxes, special assessments, or other taxes is composed of many small balances. In such cases, response rates to properly designed confirmations may be inadequate or unreliable. However, as noted in paragraph 35 of SAS No. 67, the auditor must document why the use of confirmations would be ineffective.

**8.28** For income tax revenue, the auditor considers the reasonableness of the estimation process used to record the estimated payable to or receivable from taxpayers as a group. Though it is usually not possible to establish conclusively whether all individuals or entities are paying all the income taxes due, the auditor considers whether reasonable efforts are being made to minimize nonpayment. Among the factors the auditor considers are the internal control structure over the collection of current and delinquent income taxes, methods used for determining population completeness, frequently referred to as an *enforcement* or *discovery* (for example, whether all citizens are filing income tax returns), and the taxing authority's audit and follow-up procedures related to income tax returns filed.

## Other Procedures

**8.29** Other unique audit procedures related to property tax receivables and revenue may include—

- Comparing the current year's assessed value to that of prior years and obtaining explanations of significant changes.
- Reviewing the computation of the total assessed value for property.
- Recalculating the total tax levy.
- Summarizing tax revenue and comparing recorded revenue to the current budget and prior-period actual.
- Comparing the ratio of taxes collected to those of prior years.
- Reconciling ending receivable balance to beginning receivable balance, levy, supplements, collections, abatements, and exonerations.
- Reviewing abatements, exonerations, and refunds for proper approval.
- Determining whether the list of delinquent and uncollectible taxes, if required by law, was properly filed.
- Testing compliance with the legal requirements pertaining to the sale of property for nonpayment of taxes.
- Comparing the current year's revenue from tax sales of property with revenues from prior years.
- Determining whether property parcels are improperly omitted or exempted from the tax rolls by comparing current assessment rolls to a map of the government or prior assessment rolls. Alternatively, determining that the total land area of property within the government's boundaries or within special taxing districts is consistent with that of the prior year.

**8.30** Audit procedures related to sales, income, and other taxes, governmental and other receivables, and revenues may include—

- Comparing the current year's actual revenue with the current year's budget and prior years' actual.
- Reviewing the reasonableness of the government's indirect cost allocation plan and determining the propriety of indirect cost items allocated to grant programs.
- Reviewing grant applications, agreements, contracts, budgets, and reports to determine that grant expenditures are in accordance with grant agreements.
- Reviewing grant records for material areas of noncompliance and questioned costs.
- For governments involved in matching fund grants, reviewing supporting documentation to support unit's contribution and determining allowability of any in-kind (goods or services) matching efforts to grant terms.
- Considering the propriety and consistency of revenue recognition principles.
- Evaluating the adequacy of liabilities for probable income or other tax refunds.

**8.31** Audit procedures related to interfund transactions and receivables may include—

- Considering whether interfund transactions are properly approved.
- Evaluating whether the fund receiving an advance has the ability to repay the advance.
- Considering whether permanent interfund advances are recorded as equity transfers.

- Determining the amount of any interfund borrowing that has occurred indirectly through the use of pooled cash and investment accounts.
- Evaluating whether transactions are properly classified (see GASB Cod. sec. 1800).
- Considering whether fund balance reserves are established as appropriate.
- In the case of an internal service fund that is used to account for the government's risk financing activities and that has a significant deficit or balance in retained earnings, consider whether the internal service fund revenue and the served fund expenditures/expenses are adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal (GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 66). In circumstances other than risk financing in which an internal service fund has a significant deficit or balance in retained earnings, the guidance in GASB Statement No. 10 also could be considered.

## Chapter 9

# *Expenditures and Related Liabilities*

### Introduction

**9.01** In governmental fund accounting, the term *expenditures* is used to indicate decreases in financial resources or increases in current liabilities and, accordingly, is not limited to cash payments. The auditor should understand governmental fund expenditures and related liabilities and the unique reporting practices in government related to certain expenditures.

**9.02** Generally, expenditures are classified according to character as current operating (for example, payroll, fringe benefits, or public safety administration), capital, intergovernmental, or debt service expenditures. Capital expenditures are discussed in chapter 10, "Capital Expenditures and Related Fund and Account Group Activity." Expenditures related to government grants and other assistance programs are discussed in Part VII, "Audits of Federal Financial Assistance." Debt service expenditures are discussed in chapter 11, "Debt and Debt Service." In addition, chapter 12, "Interfund Transactions and Fund Equity," discusses interfund transactions including expenditures made by one governmental fund for another governmental fund and interfund operating and equity transfers.

### Nature of Transactions

**9.03** The term *modified accrual basis of accounting* is used to describe expenditure and liability accounting in governmental funds for two reasons. First, the primary objective of accounting in governmental funds is to reflect the sources and uses of financial resources, not to allocate costs to the periods benefitted. To meet that objective, the measurement focus is on expenditures and not expenses. Second, in governmental fund accounting, the definition of *current liability*, as presented in GASB Cod. secs. C50.104 and C60.111, differs from that used by business enterprises.

**9.04** To assure that budgets are not overspent, most governmental units use an encumbrance system to track outstanding purchase commitments that have not yet resulted in liabilities. GASB Cod. sec. 1600.123 defines encumbrances as "commitments related to unperformed (executory) contracts for goods or services." When a purchase order contract is issued or any other commitment is made, the governmental unit reduces the amount of budgetary authority remaining in the budget category and records an outstanding encumbrance. When the goods or services are received, the encumbrance balance is reduced and the expenditure and liability are recorded.

**9.05** In governments, a warrant is an order issued by a legislative body or a responsible government official authorizing the governmental unit's treasurer to pay a specific amount to a specific person or to the bearer. A warrant may be payable on demand; in that case, a bank check is issued or a cash disbursement is made. A warrant may also be payable only out of certain revenues when and if those revenues are received; in that case, the warrant is recorded as an account payable.

**9.06** An expenditure is usually recognized when the government has received and becomes liable for the payment for goods and services. That is, an expenditure is generally recognized in the period in which the amount can be objectively measured, the goods or services are delivered or received, and title has passed.

## Accounting and Auditing Considerations

**9.07** Accounts payable and related liabilities usually are substantiated in conjunction with operating expenditures. However, there are unique aspects of accounting for certain governmental fund expenditures and related assets or liabilities in the areas of inventory and prepaid items, long-term liabilities, and encumbrances.

## Payroll and Related Liabilities

**9.08** Payroll expenditures include salaries, wages, and benefits (sick leave, vacation, and pension). (Guidance on accounting for compensated absences is provided in GASB Cod. sec. C60.) Personnel-related policy and procedure considerations include the following:

- Civil service requirements for hiring, promoting, and terminating employees
- Union contracts establishing wage rates and benefits
- Budgetary control over the number of employees authorized by department or function
- Permitted overtime

Grant agreements sometimes contain restrictions on the maximum salaries or wages and benefits that can be expended from, or charged to, that grant program.

## Inventory and Prepaid Items

**9.09** Under current governmental fund accounting principles, a government may record the resources used to purchase inventory or other prepaid items as an expenditure either when purchased or when consumed. That is often referred to as the purchase versus consumption option. Under the consumption method, items are recorded as assets when received and charged to expenditures as used. Some governments using the consumption method also elect to reclassify an amount equal to the year-end inventory on hand or prepaid items from unreserved and undesignated fund balance to a reserve for inventory or prepaid items. The intent of the reclassification is to demonstrate the extent to which the fund balance is composed of resources that are not available for other discretionary expenditures. Under the purchase method, items are initially recorded as expenditures. Inventory on hand is recorded as an asset with a corresponding credit to fund balance as reserve for inventory. (See chapter 12, for a discussion of reserves.) With regard to capitalization contributions (contributions sometimes made by state and local governmental entities to meet initial or ongoing capital minimums when forming a public entity risk pool), auditors should refer to GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*, to determine whether these contributions should be recorded as prepaid insurance.

**9.10** Inventory in governmental funds usually consists of materials and supplies used in the performance of the governmental function rather than ma-

terials that enter into the cost of a product that produces revenue. In that sense, the governmental fund inventory, if recorded, is similar to prepaid items. Accordingly, governmental fund inventories are generally not written down from cost to lower market values unless the usability of the inventory is affected by physical deterioration or obsolescence.

## Purchasing

**9.11** The compliance considerations pertinent to purchasing activities include whether competitive bidding is required and what requirements are imposed by local or state ordinances, bond covenants, and grant provisions. Many local ordinances or state statutes require competitive bidding for certain purchases in excess of a specified dollar amount (for example, \$5,000). Auditors should be alert to circumvention of competitive bidding requirements, by, for example, intentionally splitting large purchase orders to fall below the statutory limit, preparing purchasing specifications that are so restrictive that only one vendor is able to qualify, setting quantity levels sufficiently large to eliminate small vendors, or extending contracts with one vendor when other vendors are available to provide the needed goods or services. Consecutive purchase orders to the same vendor for amounts slightly below the statutory limit is one indication that the governmental unit is circumventing this requirement.

## Encumbrances

**9.12** Encumbrances represent neither expenditures nor liabilities. In many governments, encumbrances outstanding at the end of a period are carried forward as a reservation of fund balance, with a corresponding reduction in unreserved fund balance. (See chapters 6, “The Budget,” and 12 for discussions of encumbrances.)

## Liabilities Resulting From Uninsured Risk

**9.13** As a result of rising insurance costs, many state and local governments have elected not to purchase insurance coverage for a wide range of risks. Other governmental units have insurance policies that cover losses only in excess of extremely high amounts, namely an umbrella or stop-loss type coverage. Each of those situations is often referred to as *self-insurance*. Because no insurance is involved, the term *self-insurance* is a misnomer and the policy is more accurately described as *risk retention*.

**9.14** The types of risks involved include, but are not limited to, workers' compensation, automobile, general liability, and public officials' liability. Many of those risk areas involve a high occurrence of claims. Accordingly, at any given time, there are usually a significant number of claims in all phases of processing and adjudication. In addition, there will exist *incurred but as yet unreported* claims that usually are referred to as incurred but not reported (IBNR) claims. Whether a government elects to record such liabilities and costs directly in the general fund, individual funds, or through an established internal service fund, it is important that expected costs of the claims are properly recorded in the funds assuming the risks and that the recorded liabilities represent unreported as well as reported claims. GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, and FASB Statement No. 5, *Accounting for Contingencies*, discuss the accounting for contingent liabilities related to uninsured risks. See

also GASB Statement No. 17, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements: Amendment of the Effective Dates of GASB Statement No. 11 and Related Statements*, which supersedes paragraph 82 of GASB Statement No. 10. The GASB has also issued GASB Statement No. 30, *Risk Financing Omnibus*, which is effective for financial statements for periods beginning after June 15, 1996, with early application encouraged.

### **Amounts Resulting in Long-Term Liabilities**

**9.15** Any expenditure not paid for immediately results in a liability that is recorded as an account payable, an accrued liability, or a long-term liability. If the liability is payable currently, it is recorded in governmental funds as a current or fund liability, and a related expenditure is reported on the operating statement. However, portions of certain governmental liabilities, such as claims and judgments, compensated absences, special termination benefits, landfill closure and postclosure care, and pension costs, are not payable currently. The noncurrent portions of those liabilities are reported in the general long-term debt account group (GLTDAG) and no expenditure is currently recognized. (See GASB Cod. sec. 1500.103 and chapter 11, “Debt and Debt Service,” for discussion on the GLTDAG.)

## **Financial Statement Presentation and Disclosure**

### **Expenditures**

**9.16** Governmental fund expenditures are presented in two different statements, which are described in the following two paragraphs.

**9.17** *A Combined Statement of Revenues, Expenditures, and Changes in Fund Balances—All Governmental Fund Types and Discretely Presented Component Units.* Expenditures are typically presented as current operating, capital, intergovernmental, and debt service expenditures. In addition, the operating expenditures are presented by function, such as general government expenditures or public safety expenditures. This statement presents revenues and expenditures on the modified accrual basis of accounting.

**9.18** *A Combined Statement of Revenues, Expenditures, and Changes in Fund Balances, Budget and Actual—General and Special Revenue Fund Types (and similar governmental fund types of the primary government for which annual budgets have been adopted legally).* This statement presents a comparison of budget to actual for all governmental fund types for which annual budgets are adopted legally. In this statement, actual results are presented on the same accounting basis as the budget, even though the budget basis may not conform to GAAP. The most frequently observed difference between budgetary accounting and GAAP is the budgetary treatment of outstanding encumbrances as expenditures. Other differences can result from other basis of accounting issues, timing, perspective, or entity (see chapter 6 for a discussion of budgets).

### **Encumbrances**

**9.19** Recording encumbrances as expenditures is not in accordance with GAAP. However, the combined statement of revenues, expenditures, and changes in fund balances, budget and actual—general and special revenue fund types, should present actual operating results on the same basis of accounting as the budget. Therefore, if the budget basis reflects encumbrances

as expenditures, the actual expenditures in the budget and actual statement should also be prepared on a consistent basis (that is, actual expenditures in the statement shall also include encumbrances). The financial statements or notes are to include a reconciliation of the budgetary basis (non-GAAP) amounts to the financial statement basis (GAAP) amounts. (See GASB Cod. sec. 2400.113 to 2400.123.)

## Liabilities

**9.20** Current liabilities, commonly referred to as fund or short-term liabilities, are reported in the governmental fund balance sheet. However, as indicated previously, long-term liabilities are recorded in the GLTDAG.

**9.21 *Disclosure.*** The financial statements or the notes should include the disclosures described in GASB Cod. sec. 2300.

## Assertions

**9.22** The categories of financial statement assertions and the specific objectives applicable to expenditures and related liabilities are as follows.

- *Existence or Occurrence.* Recorded expenditures and cash disbursements are for goods or services authorized and received; payroll, wages, salaries, and benefits disbursements are made only for work authorized and performed.
- *Completeness.* Expenditures incurred for goods or services and related accounts payable are all identified and recorded.
- *Rights and Obligations.* Expenditures for goods or services are authorized and in accordance with the budget, applicable laws, regulations, or other requirements; payroll and related liabilities are computed using rates and other factors in accordance with contracts and relevant laws and regulations.
- *Valuation or Allocation.* Expenditures for goods, services, payroll, and related disbursements, and liabilities are recorded correctly and allocated properly, as to fund, budget category, account, period, and amount.
- *Presentation and Disclosure.* Expenditures for goods, services, payroll, and related liabilities are properly presented by fund type and budget category, and related disclosures are adequate.

## Internal Control Structure and Auditing Considerations

**9.23** The portion of appendix B, “Illustrative Internal Control Structure Questions—State and Local Governmental Units,” that relates to procurement and payables and to employee compensation may be considered by the auditor in performing a risk assessment.

**9.24** Many governments use one system for purchasing, accounts payable, and disbursements regardless of the number of funds maintained by the governmental unit. Similarly, governments often use a single payroll system regardless of the work locations and numbers of funds maintained. In those situations, most of the expenditure testing for all parts of a government can be done on a single expenditure or payroll system. However, some governments establish separate purchasing, accounts payable, disbursements, or payroll systems for federal grants or large special revenue funds such as school districts. In either case, controls over purchasing activities should be sufficient



to ensure compliance with competitive bidding or other requirements imposed by local or state law or ordinances, bond covenants, and grant provisions. The auditor should consider testing each significant system.

**9.25** The audit objectives for expenditures and related liabilities are similar to the objectives in the commercial environment, that is, to obtain evidence that all expenditures incurred during the period are presented in the financial statements, and related liabilities at the end of the period have been identified and properly supported, recorded, and classified. In addition, the following objectives are unique to governments:

- Expenditures are in accordance with the approved budget, as to amount and purpose, and with other applicable regulations.
- Encumbrances are properly identified, supported, classified, and recorded.
- Applicable laws and regulations are complied with relating to purchasing, payroll, grants, bond covenants, and program authorizations.
- Expenditures made for federal or other grant programs are allowable and properly classified as to the grant from which the expenditure was made.

## Chapter 10

# ***Capital Expenditures and Related Fund and Account Group Activity***

### **Introduction**

**10.01** Capital asset acquisitions for the benefit of governmental fund-type activities are generally accounted for in governmental funds and account groups. Such assets, known as general fixed assets, are capitalized and reported in the general fixed asset account group (GFAAG). Fixed asset activity in proprietary funds is discussed in chapter 13, "Proprietary Fund Types."

### **Nature of Transactions**

**10.02** Acquisitions of general fixed assets are recorded as expenditures in the general fund, special revenue funds, or the capital projects funds. Capital asset acquisitions are generally accounted for and reported based on the size and nature of the transaction, as described below, depending on the governmental unit's capital budgeting and capitalization policies:

- Small purchases of personal property, such as desks, furnishings, automotive equipment, and other small machinery and equipment used in the conduct of governmental fund-type operations, are usually shown as expenditures in the appropriate general or special revenue funds, and will be provided for in the operating budgets.
- Major projects, such as buildings, bridges, streets, parks, and storm drains, typically financed with the proceeds of bond issues, special assessment revenues, grants from other levels of government, or transfers from other funds, are often accounted for in separate project funds within the capital projects fund type.
- In some cases, assets purchased or constructed in the governmental fund types are subsequently transferred to a proprietary fund, where they are used in ongoing revenue-generating activities (for example, water and sewer lines constructed in conjunction with the operation of a utility).

### **Accounting and Auditing Considerations**

**10.03** In governmental funds, the costs associated with the acquisition of general fixed assets are recorded as current period expenditures of the respective fund. The same amount is normally recorded as an addition to general fixed assets in the GFAAG. Recording of infrastructure general fixed assets (for example, streets and storm drains) is optional according to GASB Cod. sec. 1400.109 because such assets are immovable and of value only to the government.

**10.04** GAAP provides for the GFAAG to maintain a continuing accountability for the general fixed assets acquired. Accordingly, when capital assets are recorded as expenditures in the governmental fund types, if they meet that governmental unit's capitalization policy, they are also recorded in the GFAAG as an increase in "general fixed assets."

**10.05** Other considerations regarding the accounting for general fixed assets include—

- Donated fixed assets should be recorded in the fund to which they relate or in the GFAAG, as appropriate, at their estimated fair value at the time of acquisition (GASB Cod. sec. 1400.113).
- Capitalization of interest, as provided for in FASB Statement No. 34, *Capitalization of Interest Costs*, as amended by FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*, is permitted, but not mandatory (GASB Cod. sec. 1400.111).

Although permitted, most governmental units do not opt to record accumulated depreciation in the GFAAG. Since the GFAAG is only an account group with no operating activities and the expenditures are not capitalized in the governmental fund type, no allocation of the cost of such assets among fiscal periods is made in the form of depreciation. Recording depreciation in the GFAAG results only in an entry in the account group to increase accumulated depreciation and reduce the investment in general fixed assets.

## General Fund

**10.06** The annual operating budget of a governmental unit usually includes, as a separate category, the amounts that are authorized for acquiring capital assets financed with general government revenues. The expenditure of such budgeted funds is usually recorded in the general fund or in the capital projects fund. If the expenditures are recorded in the capital projects fund, the resources used from the general fund are recorded as an operating transfer out of the general fund and as an operating transfer into the capital projects fund.

## Special Revenue Funds

**10.07** Resources such as intergovernmental grants or special assessments, which are restricted for the acquisition of capital assets, can be recorded initially in a special revenue fund to provide a single source of accountability for all the moneys received. If capital assets are acquired with those moneys, however, the accounting is the same as that described above for the general fund.

## Capital Projects Funds

**10.08** Capital projects funds are used to account for the financial resources used for the acquisition or construction of major capital facilities other than those financed by proprietary or trust funds. The capital projects fund is generally used when the expenditures are financed with debt proceeds, special assessment revenues, or capital grants. This fund is also used when the acquisition or construction of a major capital facility will occur over several fiscal years or where it is legally mandated.

**10.09** As with all governmental funds, the focus of accounting in capital projects funds is on the source and use of resources, rather than on matching revenues and expenditures. Resources accumulated in other funds for a specific project can be transferred to the capital projects fund immediately or as needed. Expenditures are recorded in the periods incurred.

**10.10** Debt proceeds are recorded in the operating statement in the period debt instruments are issued, that is, on the closing date. At the time the bonds or other debt instruments are issued and the proceeds received, the liability is also recorded in the GLTDAG with an offsetting entry to an account such as

“resources to be provided in future years,” representing the repayment requirements to be included in future years’ operating budgets to service the debt. However, no amounts are recorded until the debt instruments are issued. If a closing takes place prior to year end but proceeds are not received until early in the following year, a receivable should be established in the fund (and a corresponding liability in the account group) on the closing date.

**10.11** Capital grant revenues, addressed in GASB Cod. sec. G60, are earned when all significant terms of the grant are met. Expenditure of moneys is usually the prime factor for determining allowability of the cost and, thus, compliance with grant terms. Therefore, revenues are recognized as expenditures are incurred. If the grant agreement provides for some level of cost sharing, revenue recognition is contingent on compliance with those requirements.

**10.12** Other than for compliance with grant agreements, the matching of revenues and expenditures is not required; therefore, the fund balance of capital projects funds (as further discussed in chapter 12, “Interfund Transactions and Fund Equity”) usually represents resources earmarked for completion of capital projects in future years and is not available for other discretionary expenditures.

## Leases and Installment Purchases

**10.13** Many governments enter into lease purchase agreements, installment purchase contracts, or other forms of capital asset financing agreements. Lease accounting for general fixed assets is described in GASB Cod. sec. L20. The cost of the asset is recorded in the GFAAG and the principal amount of debt incurred (the lease or installment purchase liability), determined in accordance with FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, is recorded in the GLTDAG as a liability. The aggregate purchase liability is simultaneously recorded as an expenditure and an “other financing source” in the operating statement of the general fund or other governmental fund type acquiring the asset. Payments under the financing or lease agreement are recorded in the same manner as other debt service payments.

**10.14** Some financing lease agreements may contain a *nonappropriation*, *nonrenewal*, or *fiscal funding* clause to avoid classification as legal debt for debt limit or voter referendum purposes. Such a clause provides that, although the governmental unit will use its best efforts to make the lease payments, it may terminate the lease without penalty if its appropriating body does not allocate the necessary moneys for lease payments in future adopted budgets. This clause gives the financing the character of a one-year annually renewable lease and is not considered legal debt by a number of governmental units under the laws of their state. However, due to the nature of the property or equipment in performing essential services by the governmental unit, such agreements in many cases will meet all the criteria of a capital lease that should be capitalized for accounting and financial reporting purposes.

## General Fixed Asset Account Group

**10.15** It is essential to maintain records to demonstrate accountability for general capital assets acquired in governmental fund types, even though they are charged to expenditures as incurred in those funds. The GFAAG is used for this purpose. As expenditures are made in governmental fund types for capital assets acquired, the amount of the expenditure is capitalized in the GFAAG. When these assets are disposed of, their cost is removed from the GFAAG. Pro-

ceeds received from the disposal normally are recorded in the general fund, although some bond indentures or applicable laws may require that the proceeds be recorded in a related debt service fund, special revenue fund, or capital projects fund.

**10.16** To maintain adequate accountability, a governmental unit should conduct a periodic physical inventory of fixed assets and adjust the records accordingly.

### **Initial Fixed Asset Records**

**10.17** Because governments have accumulated fixed assets over many decades, without proper records, they may have difficulty complying with the requirement of GASB Cod. sec. 1400. However, fixed asset cost information is needed and GASB Cod. sec. 1400.112 permits the use of estimated historical costs in establishing initial property records. The extent and method of estimation should be disclosed in the notes to the financial statements.

**10.18** To establish initial property records, a government may use outside professional assistance to appraise property or may perform the following procedures internally:

- Develop a reasonably complete and accurate inventory of personal property and equipment owned, including identification of asset descriptions and an approximation of the year of acquisition. This may require taking a physical inventory. An inventory of real property is normally established through the examination of land records.
- Determine the acquisition cost, based on records or estimation procedures. One procedure is to estimate costs based on acquisition dates and manufacturers' catalogs or other information obtained through professional appraisal firms. Another procedure is to estimate current replacement costs and discount the amount to estimated acquisition cost through the use of indexes.

### **Asset Transfers**

**10.19** Occasionally, assets originally acquired by a governmental fund may be transferred to a proprietary fund, or assets originally acquired by a proprietary fund may be transferred to a governmental fund. When an asset is transferred to a proprietary fund, the GFAAG is reduced by the cost of the asset. In the proprietary fund, the asset is capitalized and recorded as contributed capital at its original cost, less an amount equivalent to the depreciation that would have been recorded had the asset been initially recorded in the proprietary fund and, if warranted, by an amount to reduce the asset to its estimated utility value. When assets are transferred to a proprietary fund, any related debt in the GLTDAG to be serviced by the proprietary fund is also transferred. Similarly, assets may be transferred from a proprietary fund to the GFAAG. In such cases, the asset is recorded in the GFAAG by an entry to the appropriate asset and investment in general fixed asset accounts, and the related debt, if any, is recorded in the GLTDAG and resources to be provided accounts. The appropriate valuation to be recorded in the GFAAG for an asset transferred from a proprietary fund can be its original cost, even if it has been depreciated, or its net depreciated value at the time of the transfer. (See paragraph 13.12 for further discussion of asset transfers.)

### **Financial Statement Presentation and Disclosure**

**10.20** The presentation of assets capitalized in the GFAAG includes the following disclosures:

- Detail of general fixed assets, such as land, buildings, and equipment
- The basis for valuing assets, for example, the cost or estimated historical cost
- Whether infrastructure assets are included or excluded
- Whether accumulated depreciation is reported and, if so, the depreciable lives and methods of depreciation
- A reconciliation of changes in the GFAAG during the year

**10.21** Other related disclosure requirements include the following:

- Capitalization of interest, if any, during construction
- Commitments under long-term construction projects
- Pertinent data regarding capital and operating leases

## Assertions

**10.22** The categories of financial statement assertions and the specific audit objectives applicable to capital expenditures and related fund and account group activity are:

- *Existence or Occurrence.* Property and equipment in the GFAAG represent a valid listing of the capitalized cost of assets purchased, constructed, donated, or leased and physically on hand.
- *Completeness.* Capital expenditures represent a complete and valid listing of all costs incurred by the acquiring fund of the property and equipment acquired during the period, and costs that meet the capitalization policy are excluded from repair and maintenance and similar expenditure accounts.
- *Rights and Obligations.* Capitalized costs and, if applicable, related depreciation associated with all fixed assets no longer owned or possessed are removed from the GFAAG.
- *Valuation or Allocation.* Property and equipment is stated at historical or estimated historical cost. Donated assets are recorded at their estimated fair value at the date of donation.
- *Presentation and Disclosure.* Capital expenditures are accounted for properly by fund type and fixed assets capitalized are classified properly by major classes of assets and related sources of funding, and related disclosures are adequate.

## Internal Control Structure and Auditing Considerations

**10.23** The portion of appendix B, “Illustrative Internal Control Structure Questions—State and Local Governmental Units,” that relates to capital assets may be considered by the auditor in performing a risk assessment.

**10.24** Government fixed asset acquisitions, particularly large projects, typically involve complex legal, contractual, and administrative requirements. For example, there are often legal regulations governing bidding and contract-awarding procedures. Also, if funding is derived from a bond issue, there are often specific bond covenant compliance requirements. If part of the funding is derived from grants or other intergovernmental funds, or if another unit of government provides a portion of the funds for a project, consideration is given to any additional specific compliance requirements.

## Audit Procedures

**10.25** Most procedures for the audit of capital acquisitions and fixed asset records of a commercial enterprise apply to such transactions for a government-

al unit. In addition, the auditor should consider performing procedures, as appropriate, relative to—

- Whether the entity has satisfactory title to fixed assets, whether any liens exist, or whether any fixed assets have been pledged.
- Whether all fixed asset expenditures are recorded, including capital leases and installment purchases.
- Whether recorded fixed assets exist, assets disposed of during the period are eliminated from the records, and proceeds, if any, from disposition are properly recorded.
- Whether capital expenditures comply with budgetary, legal, grantor, and contractual requirements.
- Whether special assessments for capital projects have been authorized appropriately and property owner assessments have been calculated properly and timely billed.
- Whether capital expenditures in the governmental funds result in the capitalization of an equivalent amount in the GFAAG.
- Whether depreciation, if recorded, is based on acceptable methods and reasonable lives, and is properly calculated.
- Whether transfers of fixed assets and related debt, if any, between the GFAAG and the proprietary funds have been recorded properly.

## Chapter 11

# *Debt and Debt Service*

### Introduction

**11.01** Governments borrow money on a short-term basis either to meet seasonal cash needs or in anticipation of long-term borrowings at later dates. They usually borrow on a long-term basis to finance fixed asset construction or infrastructure improvements, but may do so to meet other needs such as the initial funding of a risk-retention program, the payment of a claim or judgment, or the financing of an accumulated operating deficit.

**11.02** Local governments customarily are presumed not to have implicit power to borrow. Their authority to borrow usually is contained in charters or state statutes. Such authority may also prescribe the form and general terms of permitted indebtedness. Frequently, approval by governing boards or voter referendums is required.

### Nature of Transactions

#### Short-Term Borrowing

**11.03** Governments conduct short-term borrowing in several ways. For example, they borrow using tax anticipation notes collateralized by specific future tax collections. Grant anticipation notes usually require pledges of the related grants receivable. Revenue anticipation notes usually are secured by future revenues from one or more specific sources as well as by unpledged assets of the governmental units.

**11.04** Bond anticipation notes (BANs) are used primarily to provide interim construction financing and are usually retired with the proceeds of long-term debt. Terms of BANs are normally twelve months or less. They are frequently refinanced by replacement notes if the original notes mature before the long-term debt is issued. The issuance of the long-term debt may be delayed pending improvement in market conditions; however, in a governmental environment, long-term debt usually is issued prior to the start of construction.

#### Long-Term Borrowing

**11.05** Governmental long-term debt includes general obligation bonds, revenue or limited obligation bonds, capital leases, and other obligations with long-term repayment schedules. (Revenue bonds are discussed in chapter 13, "Proprietary Fund Types.")

**11.06 *General Obligation Bonds.*** General obligation bonds pledge the full faith and credit of the government. Often, specific authorization for each issue of such bonds is required in addition to general statutory authority for issuance. For example, a statute may permit a government to issue general obligation bonds up to a certain maximum, known as the debt limit, but each issuance may require the prior approval of a senior governmental unit. Because future annual principal and interest payments are supported by the taxing power of the governmental unit, a referendum or prior voter approval is often required to permit additional taxation.



**11.07 *Revenue Bonds.*** Revenue or limited-liability bond authorization procedures are similar to those for general obligation bonds. Specific receipts, such as certain restricted revenues, user fees, or special taxes (for example, special assessments, gasoline tax, and highway or bridge tolls), are often pledged to repay such bonds. Tax-increment bonds sometimes are issued in connection with economic development projects where future property tax revenues to be generated by new development are pledged to pay for the obligations issued. Depending on the expectations for future revenues, the full faith and credit of the governmental unit may be pledged for such bonds.

**11.08 *Lease-Rental Bonds.*** These bonds are issued by a related special entity, either governmental or not-for-profit, to finance public facilities such as schools, jails, or airports that are leased under contract to the governmental unit. A typical example is an equipment purchase contract that provides for either installment payments over a period of years or a capital lease financed by use of certificates of participation (COPs). The governmental unit pays rent sufficient to service the annual principal and interest debt payments. By the inclusion of budgetary *fiscal funding* or cancellation clauses in the lease, the lease-rental bond frequently is used to avoid borrowing restrictions, including debt limits, on governmental units that normally would levy taxes to pay debt obligations. A fiscal funding or cancellation clause provides that if lease payments are not appropriated in any future year budget, the lease is canceled. Leases are discussed in GASB Cod. sec. L20.

**11.09 *Other Long-Term Obligations.*** Governmental units may have other long-term obligations that are not classified as debt, as defined in this chapter, such as obligations for pensions, employee benefits, special termination benefits, landfill closure and postclosure care, operating and capital leases, and other claims, judgments, and compensated absences, which are discussed in GASB Cod. secs. C50, C60, L20, P20, and T25. The long-term portion of those obligations should be included in the GLTDAG.

## Guarantees and Other Commitments

**11.10** In addition to formal debt, a governmental unit is often involved in guarantees, moral obligation, no-commitment, or so-called conduit indebtedness. The term *conduit* means that the sponsoring governmental unit undertakes no commitment to pay or guarantee the debt service payments, but merely gives the underlying obligor access to the tax-exempt market.

**11.11 *Guarantees.*** Guarantees relate to the debt issue of another entity, for example, a local governmental obligation guaranteed by a state.

**11.12 *Moral Obligations.*** A government may issue bonds for which another entity has assumed a moral responsibility that is not an enforceable promise to pay. An example is a debt issued by a local government for which the state government is obligated, in the event of default, to consider assuming responsibility for total repayment or to consider annually the necessity to provide the required debt service payments. Moral obligations are usually unenforceable unless authorization to pay is adopted by the state legislature.

**11.13 *No-Commitment Debt or Conduit Debt.*** A governmental entity may authorize the issuance of debt bearing its name for the benefit of a private entity that is not a component unit as defined by GASB Cod. sec. 2100, and for which it assumes no responsibility for repayment, for example, as in industrial development bonds. The proceeds from the sale of such debt usually

are used in the public interest, such as for home or hospital construction, or the expansion of a private business to increase employment, or the government's tax base. Normally, such debt is repayable only by the entities for whom the debt is issued. Conduit debt explicitly states the absence of obligation by the government other than possibly an agreement to assist creditors in exercising their rights in the event of default. GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*, provides certain disclosure requirements for conduit debt obligations (see paragraph 11.32 for a description of the disclosure requirements).

## Accounting and Auditing Considerations

### Reporting Proceeds of Debt

**11.14** The accounting procedures for recording governmental fund debt depend on whether the debt is short term or long term and whether the debt is a general obligation debt or specifically identified as an obligation of a proprietary fund.

**11.15** Short-term obligations, generally with maturities of less than one year, are recorded directly as a liability in the governmental fund issuing the debt, consistent with the current operating measurement focus ascribed to governmental fund-type accounting. Proceeds received by a governmental fund in exchange for short-term debt are recorded as an asset of the fund with a corresponding credit to a fund liability; *other financing sources* are not reported in the operating statement. Some debt agreements have due-on-demand clauses even though future maturity dates are stated. A debt with a due-on-demand clause is recorded as a liability of the fund that is responsible for repaying the debt unless the debt meets the criteria of GASB Cod. sec. D30. BANs that meet the criteria of GASB Cod. sec. B50 and demand bonds or debt with a due-on-demand clause that meet the criteria of GASB Cod. sec. D30 are classified as long-term debt.

**11.16** General long-term obligations are recorded in a separate set of accounts known as the GLTDAG and offset by two contra accounts: amount available in debt service fund and resources to be provided in future years. The fund balance of the debt service fund generally equals the contra account, "amount available in debt service fund," in the GLTDAG.

**11.17** Proceeds received for long-term debt are recorded as an *other financing source* in the statement of revenues, expenditures, and changes in fund balance for the fund receiving the proceeds of the long-term debt, and the principal amount is recorded in the GLTDAG. All proceeds and costs of issuing the debt are recorded and no debt-related transactions are shown on a net basis. GASB Cod. sec. 1500 provides further guidance on the accounting for transactions related to the issuance of long-term obligations.

**11.18** A discount on general long-term debt is reported through the recording of the actual proceeds in the receiving fund, but a premium received in excess of the face amount of debt is recorded as debt proceeds in either the receiving fund or related debt service fund. Accordingly, premium or discount on long-term debt issued by governmental funds usually is not amortized. The face amount of the obligation is recorded in the GLTDAG.

**11.19** General obligation bonds collateralized by the taxing power of the government but expected to be retired from proprietary fund revenues should be reported as liabilities in proprietary fund financial statements rather than in the GLTDAG.

**11.20** The financial statements should identify appropriately those elements of any indebtedness that is secured by the full faith and credit of the government.

### **Capital Leases and Installment Purchases**

**11.21** Capital leases and installment purchases, including COPs, also create long-term obligations. The present value of the minimum payments represents the amount of the initial debt. The accounting requirements for these types of transactions are contained in GASB Cod. sec. L20.

**11.22** If the lessor is a component unit, as defined in GASB Cod. sec. 2100, such as a building authority created by the governmental unit solely to finance construction for the governmental unit, the component unit is blended with the governmental unit. In such cases, the debt of the lessor is reported as the debt of the governmental unit in the GLTDAG and the debt between the lessor and the governmental unit is eliminated. (Capital leases are further discussed in chapter 10, "Capital Expenditures and Related Fund and Account Group Activity," and capital lease arrangements and blended component units are further discussed in chapter 15, "Special Governmental Units," paragraphs 15.21 through 15.25, herein.)

### **Recording Principal and Interest Expenditures**

**11.23** The recording of governmental fund debt service payments depends on whether the debt is short term or long term. The payment of short-term debt is recorded in the fund in which the debt is recorded, as a reduction of the recorded liability.

**11.24** A debt service fund is normally used to accumulate resources to be used to make debt service principal and interest payments on general obligation long-term debt. Financial resources often are provided in other governmental funds and transferred to the debt service fund through operating transfers.

**11.25** Long-term debt usually requires annual principal and semiannual interest payments to outside fiscal agents or individual bond holders. The general long-term debt is recorded in the GLTDAG until a principal installment is due. On the due date, matured bonds are removed from the GLTDAG and recorded as an expenditure and liability of the applicable debt service fund or other paying fund. Interest expenditures for all general long-term debt are recognized in the accounting period in which they are due, rather than as they accrue. On the other hand, if debt service fund resources have been provided in the current year for payment of principal and interest due early in the following year, the expenditure and related liability may be recognized in the debt service fund and the debt principal removed from the GLTDAG.

**11.26** A general obligation debt indenture may establish reserve fund requirements for the accumulation of debt service resources. Many general obligation bonds, including certain special assessment obligations, create separately identified tax levies collected in amounts that are sufficient and timely to meet the principal and interest payments when due. Though only required when mandated by law or agreement, an individual debt service fund is often established for each debt issue.

### **Advance Refundings and In-Substance Defeasances**

**11.27** If new debt is issued to repay existing outstanding debt (a refunding), the new liability (the refunding debt) is recorded in the GLTDAG. The proceeds from the new issue are recorded in the fund receiving the proceeds as

*an other financing source—proceeds of refunding bonds.* Most advance refundings result in defeasance of debt. When the old debt is defeased, it is no longer reported as a liability in the GLTDAG; only the new debt is reported. Payments to the escrow agent from resources provided by the new debt should be reported as *an other financing use—payment to refunded bond escrow agent.* Payments to the escrow agent from other resources of the entity should be reported as debt service expenditures. The accounting and disclosure requirements for refundings and defeasance of debt are described in GASB Cod. sec. D20 and GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities.*

## Debt Limits

**11.28** Most governmental units have some form of outstanding debt limitations imposed by state or local laws. These limitations can be all-inclusive for all forms of debt outstanding, or may be structured so there are separate limitations for different forms of debt (for example, general obligation, revenue, installment, and lease purchase), or be dependent on the purpose for which the debt was issued (for example, equipment, water and sewer, transportation). Other limitations on the form, type, or amount of debt are imposed by federal tax laws and related IRS regulations. Management is responsible for identification and compliance with applicable laws and regulations.

## Arbitrage

**11.29** The Internal Revenue Code (IRC) and arbitrage rebate regulations issued by the IRS require rebate to the federal government of excess investment earnings on bond proceeds if the yield on those earnings exceeds the effective yield on the related tax-exempt bonds issued. Regulations also exist for calculating rebate earnings in connection with the accounting for bond proceeds, refunding issues, and proceeds that are commingled with other funds for investment purposes. Governmental units that issue \$5 million or less in tax-exempt indebtedness during a calendar year are not subject to the rebate requirements if at least 95 percent of the net proceeds are used for government activities of the issuers. For this purpose, tax-exempt indebtedness includes bonds and certain capital leases and installment purchases. Rebates are payable every five years or upon maturity of the bonds, whichever is earlier. Arbitrage liability is calculated annually and practice supports recording the liability in the governmental fund that will make the payment or the GLTDAG.

## Financial Statement Presentation and Disclosure

### Presentation

**11.30** The financial statements should reflect the following:

- Short-term debt is recorded as a liability in the issuing fund, except for BANs meeting the criteria of GASB Cod. sec. B50.
- Demand bonds meeting the criteria of GASB Cod. sec. D30 are recorded as long-term debt.
- Special assessment debt is recorded according to requirements of GASB Cod. sec. S40.
- General obligation long-term debt repaid from governmental funds is recorded in the GLTDAG and offset by two accounts: amount available in debt service funds and resources to be provided in future years.
- General obligation long-term debt repaid from proprietary funds is recorded in the related proprietary fund.

- The principal portion of capital leases is recorded as debt.
- The proceeds of general obligation long-term debt are recorded as an *other financing source* in the governmental fund receiving the use of the debt proceeds.
- Principal and interest payments on governmental fund debt are recorded as expenditures when payable in the fund designated to make the payments.

## Disclosure

**11.31** Financial statements should disclose the nature of any restrictions on assets related to any outstanding indebtedness. Other related disclosures may include the following:

- The maturity, interest rates, and annual debt service requirements to maturity for the short-term and long-term issues of outstanding indebtedness
- The issuance and payment of debt for the period
- Details of capital leases
- Amounts of authorized but unissued debt
- The existence of any significant bond covenants and liquidity agreements
- Violations of bond covenants
- The nature and amount of contingent and moral obligations, and no-commitment debt, and any actions by the government to extend an obligation to pay
- The amount of unpaid defeased debt
- The refunding of debt, including the difference between the cash flows to service the old debt and the cash flows to service the new debt, and the economic gain or loss resulting from the transaction
- The debt issued subsequent to the balance-sheet date but before the financial statements are issued
- An existing or anticipated inability to pay debt when due
- Information on derivatives and similar debt transactions as required in GASB Technical Bulletin No. 94-1, *Disclosures About Derivatives and Similar Debt and Investment Transactions*

**11.32** The financial statements should identify any outstanding indebtedness of others guaranteed by the government, even if the possibility of default is remote. Any governmental unit assuming a moral obligation should disclose such circumstances in the notes to its financial statements (see paragraph 11.12 for the definition of moral obligation). For any conduit debt, because a default may adversely affect the government's own ability to borrow, practice supports display or disclosure of the existence of such debt in the financial statements. At a minimum, GASB Interpretation No. 2 requires certain disclosures for conduit debt obligations. The required disclosures include a general description of the conduit debt transactions, the aggregate amount of all conduit debt obligations outstanding at the balance sheet date, and a clear indication that the issuer has no obligation for the debt beyond the resources provided by related leases or loans.

## Assertions

**11.33** The categories of financial statement assertions and the specific audit objectives applicable for debt and debt service expenditures can be related as—

- *Existence or Occurrence.* Debt is authorized and recorded in the proper fund type or the GLTDAG.
- *Completeness.* All indebtedness of the governmental unit is identified, recorded, and disclosed.
- *Rights and Obligations.* The governmental unit has complied with the provisions of indentures and agreements related to debt, including provisions on the use of proceeds.
- *Valuation or Allocation.* Debt service expenditures (principal and interest payable) are properly recorded, classified, and disclosed for current and future periods.
- *Presentation and Disclosure.* Debt and related restrictions, guarantees, and commitments are properly presented in the combined financial statements, and related disclosures are adequate.

## Internal Control Structure and Auditing Considerations

**11.34** The auditor acquires an understanding of the internal controls for the authorization, issuance, and repayment of debt. This understanding considers the specific audit objectives for debt and debt service expenditures related to the financial statement assertions. Many audit objectives related to the debt of governments are similar to audit objectives for the debt of business enterprises. However, the governmental environment makes certain modifications of audit objectives necessary. The auditor should consider obtaining evidence that—

- New debt issues are properly authorized.
- Indebtedness, including liabilities incurred under court order, lease purchase agreements, and other commitments, is identified and properly recorded or otherwise disclosed in the financial statements.
- Debt is recorded in the proper fund or the GLTDAG.
- Debt and related interest payable are properly recorded and classified as to terms and payment status and disclosed in the financial statements.
- Taxes levied to service the debt are adequate.
- The governmental unit has complied with the provisions of indentures and agreements relating to indebtedness, particularly on the use of proceeds, including any restrictions on the use of those proceeds prior to expenditure for their intended purpose.
- Debt restrictions are properly disclosed in financial statements or notes.
- Guarantees and other debt commitments are properly disclosed.
- Arbitrage rebate liabilities have been computed and recorded as a liability.

**11.35** There is a presumption that assets identified in the financial statements as restricted satisfy legal requirements or bond indentures, unless there is disclosure to the contrary. If assets restricted for debt retirement include amounts due from other funds or from unrestricted assets of the same fund, there is an implication of noncompliance with the requirement for restriction of the assets. In such situations, the independent auditor should consider the adequacy of the accounting, disclosures, and other reporting considerations.

## Audit Procedures

**11.36** Confirmations may be used to verify the following:

- Principal balances outstanding at the balance-sheet date

- Principal and interest payments to fiscal agents during the year and any cash held for payment of unrepresented bond or interest coupons
- Legal compliance of debt sales and the applicability of arbitrage restrictions with bond counsel or appropriate oversight government
- The existence of any restrictions, terms, and proceeds with the lender or underwriter
- Compliance with appropriate covenants with the trustee

**11.37** In addition to procedures followed in auditing other enterprises, the independent auditor should consider the following audit procedures related to a governmental entity's debt:

- Review legislative proceedings and enactments, and inquire whether all debt bearing the name of the reporting entity or any of its component entities is identified and is properly disclosed in the financial statements and notes.
- Review documentation and transactions for support of the intent and ability to pay general obligation debt from proprietary funds.
- Examine significant lease agreements for conditions requiring the capitalization of assets and related liability.
- Obtain information as to the existence of any guarantees or commitments related to the issuance of debt of other organizations.
- Review sinking fund calculations to determine the reasonableness of amounts accumulated to service debt.
- Review loan and debt agreements to determine whether any assets are pledged and if there are any restrictive covenants.
- Evaluate whether the governmental unit is in compliance with provisions of indentures and restrictive covenants, including provisions on the use of proceeds.
- Review the disposition of interest-earning and unexpended debt proceeds for compliance with bond covenants or legal statutes.
- Review procedures for calculating and recording any arbitrage rebate liability.
- Review the debt limit calculation and computation of any special tax levy-related debt service payments.

## Chapter 12

# Interfund Transactions and Fund Equity

### Introduction

**12.01** The need to properly account for and report interfund transactions and relationships and the composition of fund equity balances is unique to the governmental fund accounting environment. GASB Cod. sec. 1800 provides guidance regarding the classifying and reporting of interfund transactions and fund equity balances.

### Nature of Transactions

**12.02** Interfund transactions are divided into two categories with various subcategories. The first is revenues and expenditure/expense transactions consisting of reimbursements and quasi-external transactions. The second is the reallocation of resources transactions consisting of temporary interfund loans or advances, permanent residual equity transfers, or operating transfers. In addition, asset or liability accounts are used to record short-term amounts owed to one fund by another fund within the same reporting entity, or for goods or services rendered, where one fund incurs the liability for an expenditure/expense chargeable to another fund.

**12.03** The equity of governmental fund types is classified as the fund balance and is composed of either reserved or unreserved balances. Generally, reserves are established to indicate a claim against assets or to identify certain assets not available for appropriation. The unreserved portion is further classified as designated or undesignated. The designations of fund balances originate through actions of either the executive or legislative branches of the governmental unit and indicates the tentative future use of available resources. Designations should be distinguished clearly from reserves, since managerial plans are subject to change and may never be legally authorized or result in expenditures.

### Accounting and Auditing Considerations

#### Interfund Transactions

**12.04** Interfund revenue and expenditure/expense transactions fall into the following categories:

- **Reimbursements.** Transactions that constitute reimbursements of a fund for an expenditure/expense initially made from it that is properly applicable to another fund. For example, an expenditure properly chargeable to a special revenue fund was initially recorded in the general fund, which, when subsequently reimbursed, is recorded as an expenditure in the special revenue fund and as a reduction of the expenditure account in the general fund. The interfund reimbursement accounting method is not used to record transactions that properly represent transfers between funds.
- **Quasi-External Transactions.** Transactions that would be accounted for appropriately as revenue and expenditures or expenses, if they involved organizations *external* to the governmental unit. Examples



include payments in lieu of taxes by an enterprise fund to the general fund, employer contributions from the general fund to the employer pension trust fund, internal service, or enterprise fund charges to other funds for goods or services based on established user charges.

**12.05 Reallocation of resources-type transactions consists of the following:**

- ***Interfund Loans or Advances.*** These are the transfer of moneys between funds within the same entity, usually for working capital purposes with the expectation of repayment, where no goods were sold or services rendered.
- ***Residual Equity Transfers.*** These are the nonrecurring or nonroutine transfer of equity between funds. In the governmental fund types, residual equity transfers are reported on the operating statement as additions to or deletions from the beginning fund balance. In the proprietary fund types, residual equity transfers are reported as additions to contributed capital, or as reductions of contributed capital or retained earnings, as appropriate.
- ***Operating Transfers.*** These are all other legally authorized interfund transfers, other than residual equity transfers, from a fund receiving revenue to a fund through which resources are expended. Examples include the transfer of tax revenue from the general fund to the debt service fund for debt service payments, the transfer of highway toll revenue from a special revenue fund to the capital project fund for the construction of a fixed asset, and the transfer of an operating subsidy from the general fund to an enterprise fund to support operations. Operating transfers are neither revenue, expenditure, nor expenses, and, therefore, are classified as *other financing sources/uses* in the operating statement in the governmental fund types and in a separate subsection before net income in the proprietary fund types.

## Fund Balance

**12.06** The total fund balance is subdivided into two categories, as applicable, reserved and unreserved.

**12.07 *Reserved Fund Balances.*** Reservations of fund balance are established to indicate that a portion of the fund balances is (a) legally segregated for a specific use (for example, a contractual commitment to third parties that has not materialized as a liability at the balance sheet date), or (b) not appropriable for expenditure because the underlying net asset is not an available financial resource for current appropriation or expenditure (for example, inventories, prepaid items, noncurrent receivables, or interfund advances). Such reserves are not intended as valuation allowances, but merely demonstrate the current unavailability of the assets to pay current expenditures. If a valuation allowance is required, it is presented as a reduction of the carrying amount of the asset. In addition, if the collectibility of an interfund receivable is doubtful, consideration is given to reclassifying the amount as a transfer.

**12.08 *Unreserved Fund Balances.*** Unreserved fund balances can be subdivided into designated and undesignated.

**12.09 *Designated.*** Designations indicate tentative management plans for the future use of certain financial resources that may never be legally authorized or result in expenditures. Examples of such designations include the amount to be included in the next year's budget for appropriations, available for completion of capital projects, and earmarked for unknown contingent

liabilities. Generally, designations are supported by definitive plans and approved by the governmental unit's senior management. Designations should not result in negative undesignated balances being reported on the financial statements. In such cases, disclosures of designations can be included in the footnotes.

**12.10 Undesignated.** The fund balance remaining after the reduction for reserved and designated balances is identified as the undesignated fund balance. This amount generally is equal to the amount available for future budget appropriation. However, state laws may establish minimum amounts that are accumulated before undesignated fund balances are available for appropriation and/or maximum amounts that are permitted before appropriation of any balance is required.

### Reserve for Encumbrances

**12.11** Encumbrances (discussed previously in chapters 6, "The Budget," and 9, "Expenditures and Related Liabilities"), represent commitments related to unperformed contracts for services and undelivered goods. If encumbered appropriations (budget authorizations) do not legally lapse, an amount equal to those encumbrances outstanding at year end is reclassified from the unreserved and undesignated fund balance to a *reserve for encumbrances* as a demonstration of future contractual claims against the fund balance.

### Reserves for Inventory, Prepaid Items, and Long-Term Assets

**12.12** Reserves for inventory, prepaid, and long-term assets are established to convey that such assets are not available for appropriation. Although, as noted in chapter 9, establishing reserves for inventory and prepaid items determined using the consumption method is optional, reserve accounting is required in cases where long-term assets are present. Governments using the purchase option for inventories should record the change in the required reserve as a change in fund balance.

**12.13** The aggregate fund balance of any fund is not changed by the fact that a governmental unit has, or does not have, reserves or designations. Only the financial statement presentation of the components of total fund balance is affected by the presentation of any reserves or designations.

**12.14** Changes in the aggregate fund balances can result from any of the following:

- Excesses (deficits) of revenues and other financing sources over (under) expenditures and other uses
- Changes in inventories accounted for using the purchases method
- Residual equity transfers as defined in GASB Cod. sec. 1800.106
- Prior period adjustments
- Changes in accounting principles

## Financial Statement Presentation and Disclosure

### Fund Balance

**12.15** An example of the presentation of the fund balances of a governmental entity is presented in GASB Cod. sec. 2200.903, example 1. In addition to previously described reserves and designations, which relate principally to the general fund, the fund balances of other governmental fund types can have amounts classified as reserved or designated. Reserves and designations in

such funds may relate to identified portions intended for a particular purpose or to the fact that the total balance is restricted for the purpose of the fund type. However, many governmental units do not classify such balances as reserved or designated on the basis that the nature of the respective fund types provides adequate information regarding intent. The following additional comments relate to other governmental fund types.

**12.16 *Special Revenue.*** Fund balance reserves and designations can apply to special revenue funds. Negative balances in such funds are rare because encumbrances and expenditures are not usually incurred in advance of the receipt of revenues or an event (signed grant agreement) that would support the accrual of revenues equivalent to the expenditures incurred.

**12.17 *Debt Service.*** The fund balance of debt service funds is held only for meeting debt service requirements composed of principal, interest, and fiscal charges and can be categorized as reserved or designated for debt service. The fund balance of this fund type usually determines the *amount available in debt service funds* shown in the GLTDAG.

**12.18 *Capital Projects.*** Capital projects funds are used to demonstrate compliance with legal and contractual provisions and to compile certain cost data in the construction of major capital facilities. The fund balance usually represents unexpended resources designated or reserved for specific projects.

## Changes in Fund Balance

**12.19** GASB Cod. sec. 2200.113 requires the presentation of *changes in fund balances* on the *combined statement of revenues, expenditures, and changes in fund balances—all governmental fund types and discretely presented component units*. The fund balance reconciled in that statement may be either the unreserved or the total fund balance (GASB Cod. sec. 2200.904(b)). If the statement presents changes in total fund balance, material changes in each reserve and designation should be disclosed in notes to the financial statements.

## Other Note Disclosures

**12.20** Note disclosures should include identification of a negative fund balance in any individual fund and the plans for how it will be liquidated. Designated or reserved balances not evident in the financial statements should be presented in the notes.

## Assertions

**12.21** The categories of financial statement assertions and the specific audit objective applicable for interfund transactions and fund equity are related as follows:

- ***Existence or Occurrence.*** All recorded interfund transactions, and changes in reserved, designated, and undesignated fund balance are based on actual transactions between funds or are in accordance with any contractual or legal requirements.
- ***Completeness.*** All interfund transactions and reservations and designations of fund balance are identified, recorded, and disclosed.
- ***Rights and Obligations.*** Reserves required by law or contractual agreement comply with contractual or legal restrictions. Interfund transactions are in accordance with budget, legislative, or management authorizations, as applicable.

- *Valuation or Allocation.* Interfund transactions are recorded at the correct amounts in the proper funds and are valued at appropriate amounts.
- *Presentation and Disclosure.* All balance-sheet interfund balances between funds are reconciled and disclosed, and all reserves and designations are properly classified and adequately described.

## Internal Control Structure and Auditing Considerations

**12.22** The auditor acquires an understanding of the internal controls over interfund and fund balance transactions. This understanding considers the nature of all significant types of transfers and changes in fund balance to perform a risk assessment and determine the applicable audit procedures for each.

**12.23** The auditor may need to consider the following specific audit objectives, selected control procedures, and auditing procedures.

### Interfund Transactions

**12.24** The principal objectives of the audit of interfund transactions include obtaining evidence that—

- Transactions between funds representing reimbursements or quasi-external transactions are properly classified, reported, and disclosed in the financial statements.
- Transactions between funds representing the reallocation of resources are properly authorized through legislative or budgetary actions and are properly classified, reported, and disclosed in the financial statements.

### Fund Balance

**12.25** The principal objectives of the audit of fund balances include obtaining evidence that—

- All fund balances and related transactions are reported in the financial statements in conformity with GAAP and in compliance with state and local regulations or requirements.
- The components of fund balance are properly classified and described.
- Reserves and designated balances are properly authorized.

### Audit Procedures

**12.26** For interfund transfers, the auditor should consider performing procedures, as appropriate, relative to—

- Whether all interfund transactions have been properly identified and classified by type within the financial statements.
- Whether transfers of resources are properly authorized, classified, and documented.

**12.27** For reserved and designated fund balances the auditor should consider performing procedures, as appropriate, relative to—

- Whether documentation exists supporting all required reserved fund balances.
- Whether required reserved fund balances are established; these may create a negative (deficit) unreserved fund balance.
- Whether a reserve for encumbrances is required or whether encumbrances lapse at year end under state law, local charter requirements, or other regulations.

- Whether documentation exists to satisfy the requirement that designations are required or approved by either the chief executive officer or the legislature.
- Whether the designations of fund balances do not create or increase a negative unreserved and undesignated fund balance at the balance-sheet date regardless of the amount of fund balance that existed at the time of making the designation.
- Whether the designations of fund balances recorded represent demonstration of future expenditure intentions as distinct from unperformed (executory) contracts that should be reported as encumbrances.
- Whether reserved and designated fund balances represent only classification of aggregate fund balances and are not used to absorb future charges or credits.
- Whether reserved and designated fund balances no longer required are returned to the unreserved and undesignated fund balance.

**Part III**  
**The State and Local Government Audit—**  
**Proprietary and Fiduciary Funds**

## Chapter 13

### *Proprietary Fund Types*

#### Introduction

**13.01** The proprietary funds used to account for a government's ongoing activities are similar to those found in the private sector and consist of *enterprise funds* and *internal service funds*.

#### Nature of Transactions

##### Enterprise Funds

**13.02** Enterprise funds account for operations that are financed and operated much like private business enterprises, meaning that the governing body has decided one of the following:

- a. The intention is that the costs (expenses, including depreciation) of providing goods and services to the general public on a continuing basis are to be financed or recovered primarily through user charges.
- b. The periodic determination of revenues earned, expenses incurred, and net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. See GASB Cod. sec. 1300.104b(1).

**13.03** Examples of enterprise funds in which user fees usually are charged to recover the costs of rendering services include the following:

- Public utilities (for example, water, sewer, gas, electric, storm water, trash, and garbage disposal)
- Recreation and cultural operations (for example, stadiums, arenas, sports facilities, convention centers, swimming pools, golf courses, and amusement parks)
- Services (for example, parking garages, toll facilities, airports, and public docks)
- Public entity risk pools

**13.04** Examples of enterprise funds used to measure periodic revenue or expense determination, capital maintenance, or to achieve separate accountability may include—

- Hospitals and health care facilities
- Transportation activities for which fare collections usually do not cover costs, and subsidies from other funds or operating grants from other governments generally are necessary to sustain operations
- Housing and urban redevelopment activities in which tenant rentals or land rates cover only a portion of costs, and subsidies or operating grants are necessary to meet operating expenses
- Food service programs of school districts

##### Internal Service Funds

**13.05** Internal service funds are used to account for goods or services provided by a central service department or agency to other departments, agencies, or component units of the governmental unit, or to other unrelated

governmental units, usually on a cost reimbursement basis. Accordingly, revenue and other financial resources of these funds should recover expenses, including depreciation. (See GASB Cod. sec. 1300.104b(2).)

**13.06** Examples of internal service fund activities include the following:

- Communications servicer (telephone and mail)
- Data processing
- Printing and duplication
- Motor pools and maintenance operations
- Central supply stores
- Building occupancy and maintenance
- Risk retention

## Accounting and Auditing Considerations

### Generally Accepted Accounting Principles

**13.07** GAAP for proprietary funds are generally those applicable to similar businesses in the private sector; the measurement focus is on the determination of net income, financial position, and cash flows. All assets, liabilities, equities, revenues, expenses, and transfers relating to the government's business, including fixed assets and long-term debt, are accounted for in a single proprietary fund rather than in a series of funds and account groups.

**13.08** SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), describes the hierarchy of pronouncements applicable to governmental entities. GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, provides guidance on accounting and financial reporting for proprietary funds and entities that use proprietary fund accounting and reporting. Proprietary funds should apply all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Statements and Interpretations of the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB) Opinions and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure. In addition, a proprietary fund may also apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. That is, a proprietary fund should apply either all or none of the FASB pronouncements issued after November 30, 1989. The same application of FASB pronouncements is encouraged to be used for all proprietary funds, including component units, in the general-purpose financial statements of the financial reporting entity.

### Billings and Customer Receivables

**13.09** Governments usually bill utility customers on cycle dates on a monthly or multimonthly billing basis. Cycle billing may result in material unbilled receivables at the end of an accounting period. For example, if meters are read and billed quarterly on cycle dates spread evenly throughout the quar-



ter, an average of forty-five days' service for the entire customer base is unbilled at the end of the accounting period. However, consideration is required as to the characteristics of the billing period, such as seasonal usage. Proprietary funds should record estimated unbilled services, if material.

## Customer and Developer Deposits

**13.10** Many utility-type enterprise funds require customer deposits to assure timely payment for services. Deposits are normally required before service starts and are refunded when service is terminated. Land developers may also be required to make good-faith deposits to finance the cost of extending utility service lines.

**13.11** Unearned deposits from customers and developers are initially recorded as liabilities in proprietary funds. Customer deposits remain in liabilities until they are applied against unpaid billings or refunded to customers. Developer deposits are reclassified as contributed capital or recognized as revenue when they are no longer refundable. The accounting for such deposits is being addressed in the GASB's contributed capital project. With regard to capitalization contributions (contributions sometimes made by state and local governmental entities to meet initial or ongoing capital minimums when forming a public entity risk pool), auditors should refer to GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*, to determine whether these contributions should be recorded as deposits.

## Property, Plant, and Equipment

**13.12** Fixed assets are constructed or acquired by proprietary funds from existing resources, capital contributions or grants, or borrowed funds. Fixed assets also are acquired or constructed in capital projects funds and contributed to proprietary funds. Assets acquired through other funds in prior years and recorded in the GFAAG are sometimes later contributed to a proprietary fund. The latter is especially likely in the case of newly established proprietary funds. Assets transferred from the GFAAG after some portion of the economic life of the assets has expired are recorded in the proprietary fund at original cost less an amount equivalent to the depreciation that would have been recorded had the asset been initially recorded in the proprietary fund and, if warranted, by an amount to reduce the asset to its estimated utility value. Fixed assets that are transferred from proprietary funds to the GFAAG are removed from the proprietary fund at book value, that is, no gain or loss is recognized in the proprietary fund. (See chapter 10, "Capital Expenditures and Related Fund and Account Group Activity," paragraph 10.19 for further discussion of asset transfers.)

**13.13** When appropriate, interest incurred to construct a fixed asset should be capitalized in accordance with FASB Statements No. 34, *Capitalization of Interest Costs*, and No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*. The accounting policy with respect to capitalization of interest should be disclosed and consistently applied.

## Long-Term Debt

**13.14** Proprietary funds, particularly utility-type enterprise funds, frequently finance capital construction by issuing general obligation bonds or revenue bonds. Revenue bonds usually are repayable solely from pledged rev-

enues—hence, the name revenue bonds—or they are sometimes referred to as *double-barreled* bonds, when, in addition to the pledged revenue stream, they are secured by a pledge of the full faith and credit of the issuing governmental entity.

**13.15** Regardless of the type of security, general obligation bonds and revenue bonds (and similar hybrid debt issues) are recorded as liabilities of the proprietary fund that initiates the issuance of the bonds, benefits from the proceeds, and will repay the debt. Revenue bonds or general obligation bonds repayable by a proprietary fund are not recorded in the GLTDAG.

**13.16** Most revenue bond indentures restrict the use of unexpended bond proceeds, and many restrict other activities of the issuer. For example, many indentures restrict the use of bond proceeds to the construction or acquisition of specific assets. Other restrictions include the maintenance of prescribed net income levels or requirements to use all or a portion of the fund's net operating income in meeting current debt service payments. A sinking fund is often required to set aside resources for the payment of future debt service obligations. Other covenants may set forth requirements for the disposition of any unused proceeds of the bond issue after construction is completed. Adequate disclosure is required in the financial statements or footnotes of any significant restrictions.

**13.17** Refer to chapter 11, "Debt and Debt Service," paragraph 11.29 for a description of arbitrage requirements under the Tax Reform Act of 1986. Any liability for arbitrage payable to the federal government for debt recorded in a proprietary fund should be recorded as a liability of that fund.

### **Contributed Capital**

**13.18** The contributed capital of proprietary fund types is often provided by contributions from (a) other funds of the governmental unit, (b) grants from senior governmental units (generally the state or federal government), or (c) utility system developers or users.

**13.19** The use of capital grant funds received from other governmental units or organizations may be restricted to the construction or acquisition of specific fixed assets or other specific expenditures. Capital contributed by developers or users may be received in the form of assets or facilities other than cash (for example, utility system distribution lines).

### **Depreciation on Fixed Assets Financed by Contributed Capital**

**13.20** The proprietary fund's records should identify all fixed assets where the source of financing is contributed capital. The source of a fund's capital is an important consideration in its rate-setting process. The depreciation expense related to assets financed by capital grants is recorded in the income statement, but a governmental unit may elect to close such depreciation to contributed capital rather than to retained earnings. If this option is elected, pursuant to GASB Cod. sec. G60.116, the closeout of the depreciation is recorded by debiting contributed capital and crediting retained earnings. This entry is reflected on the income statement immediately following net income.

### **Revenue and Expense Determination**

**13.21** Revenue for goods and services provided to other funds is recorded by the fund providing the goods or services, and expenses or expenditures, as appropriate, are recorded by the fund receiving the goods or services.

**13.22** If costs related to the operations of a proprietary fund are paid by another fund (for example, employee fringe benefits paid by the general fund) and reimbursed by the proprietary fund, they are recorded in accordance with GASB Cod. sec. 1800.103b.

**13.23** If a proprietary fund provides rate-regulated services of the type and under the conditions contemplated in FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, the provisions of that pronouncement may be considered. Pronouncements related to FASB Statement No. 71 may also be applicable using the guidance in GASB Statement No. 20.

## Systems Development Fees

**13.24** Fees charged to join an existing utility system or for the extension of an existing utility system are commonly referred to as *tap fees*, *connection fees*, or *systems development fees*. In some instances, fees related to the physical connection to the system are recorded as operating income, and the related costs are expensed. In other cases, amounts assessed that substantially exceed the cost to connect are recorded as contributed capital or the entire tap fee is recorded as nonoperating revenue. The accounting for such fees is being addressed in the GASB's contributed capital project.

## Intergovernmental Grants

**13.25** Grants, entitlements, and shared revenues received by proprietary funds for operating purposes or that may be used in support of either current operating expenses or capital facility acquisition at the discretion of the recipient government are recorded as *nonoperating revenues* immediately before net income in the accounting period in which they are earned and become measurable. Those restricted for the acquisition or construction of capital assets are recorded as contributed capital. GASB Statement No. 24, *Accounting and Reporting for Certain Grants and Other Financial Assistance* (effective for financial statements for periods beginning after June 15, 1995), establishes accounting and financial reporting standards for pass-through grants, food stamps, and on-behalf payments for fringe benefits and salaries.

## Interfund Transactions

**13.26** Refer to chapter 12, "Interfund Transactions and Fund Equity," for a description of interfund transactions. Charges for services (for example, utility or usage) and payments in lieu of taxes are reported as quasi-external transactions. Operating transfers in (out) are reported immediately before net income. Residual equity transfers in (out) are reported as increases (decreases) in contributed capital, although residual equity transfers out may also reduce retained earnings.

**13.27** Proprietary funds may provide services to other funds that are recorded as revenues and expenses if they involve user charges similar to those charged to parties outside the governmental unit. Such interfund, quasi-external transactions are accounted for as revenues of the providing fund and expenses or expenditures of the receiving fund, as if they involved outside parties. Such interfund transactions generally constitute the principal source of revenues of internal service funds because those funds are established to serve user funds within the governmental unit.

## Internal Service Fund Considerations

**13.28** GAAP require internal service funds to operate on a cost reimbursement approach (GASB Cod. sec. 1300.104b(2)), which implies breakeven each year or over several years. Thus, rates should not be established at confiscatory levels that siphon off assets earmarked for other purposes. Likewise, rates should not be set so low as to incur significant losses that result in retained earnings deficits. A pattern of annual operating deficits, particularly if it results in an accumulated retained earnings deficit, indicates that the fund has failed to charge users adequately for the cost of goods or services provided by the internal service fund. Because the intent of these funds is to facilitate cost allocation, the accumulation of resources or deficits over a long term is considered inappropriate.

## Public Entity Risk Pools

**13.29** GASB Cod. sec. Po20 defines a *public entity risk pool* as a cooperative group of governmental entities joining together to finance an exposure, liability, or risk. A pool may be stand-alone or included as part of a larger governmental entity. All public entity risk pools should account for their activities in an enterprise fund regardless of whether there is a transfer or pooling of risk.

**13.30** Several specific disclosures are required for public entity risk pools, and GASB Cod. sec. Po20 requires revenue and claims development information to be included as required supplementary information (RSI). The RSI includes both information in a table format and a reconciliation of claims liabilities by type of contract. Auditors should note that GASB Statement No. 30, *Risk Financing Omnibus*, includes certain additional requirements for public entity risk pools and is effective for financial statements for periods beginning after June 15, 1996, with early application encouraged.

**13.31** Pools that do not transfer or pool risk among participants are acting as claims servicers and not insurers. The operating statements of these pools should report claims servicing revenue and administrative costs. Amounts collected or due from pool participants and paid to settle claims should be reported as a net asset or liability on an accrual basis.

## Entities Other Than Pools

**13.32** Accounting for participation in pools depends on whether the entity transfers risk to the pool or shares its risks with the risks of other pool participants, or whether it enters a pool that simply performs a claims servicing function for the entity. If an entity does not transfer or share its risks through a pool and uses a single fund to account for its risk-financing activities, that fund should be either the general fund or an internal service fund. Auditors should refer to GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*, for accounting and financial reporting guidance for capitalization contributions.

**13.33** GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, requires state and local governments other than pools that use risk management internal service funds to meet certain interfund charges guidelines, including when they are permitted to include in their rates a reasonable provision for expected future catastrophe

losses. Auditors should note that GASB Statement No. 30 includes certain additional requirements for entities other than pools and is effective for financial statements for periods beginning after June 15, 1996, with early application encouraged. (See also the GASB Staff Document, *Questions and Answers Guide to Implementation of GASB Statement No. 10.*)

## Financial Statement Presentation and Disclosure

**13.34** Enterprise funds and internal service funds are each combined in the GPFS. The totals of those two fund types are labeled *enterprise* and *internal service* and displayed in separate columns under the heading *proprietary fund types* in the GPFS.

## Summary of Significant Accounting Policies

**13.35** A summary of significant accounting policies generally discloses revenue recognition practices, asset lives, methods used to determine and record depreciation on assets, allocations of grant receipts to contributed capital pursuant to GASB Cod. sec. G60, and other applicable accounting policies as outlined in GASB Cod. sec. 2300.106.

## Segment Information

**13.36** GPFS generally contain combined information and, accordingly, the segment information described in GASB Cod. sec. 2500 is disclosed for certain individual enterprise funds of the primary government, including the blended component units. Segment information usually is disclosed in the footnotes. As noted in GASB Cod. sec. 2500.109, the financial reporting entity's financial statements should make those discretely presented component unit disclosures that are essential to fair presentation of the financial reporting entity's GPFS.

## Special Considerations—Government-Owned Hospitals and Universities

**13.37** Governmental entities frequently operate hospitals and institutions of higher education. As noted in chapter 15, "Special Governmental Units," of this guide, the provisions of the AICPA Audit and Accounting Guide *Health Care Organizations*, and GASB Cod. sec. Co5, generally apply to those activities.

**13.38** Judgment is required in determining the proper fund in which to record health care activity. For example, governmental institutions for the long-term care of the elderly, the mentally retarded, or children are often accounted for in the general fund or a special revenue fund rather than as enterprise funds when they are not user-fee supported. Hospitals operated by governments, however, generally are accounted for as an enterprise fund, as provided by GASB Cod. secs. H50 and Ho5, even if indigent care or contractual allowances are significant.

## Internal Control Structure and Auditing Considerations

**13.39** Audit objectives for proprietary funds are similar to those for business enterprises. However, as in the case with governmental financial statements generally, compliance with laws and regulations is a significant con-

sideration. Many smaller governmental entities have neither enough people nor proper internal control structure to provide adequate internal control over enterprise fund billing, collection, and accounting functions, and, therefore, the auditor may have to place more reliance on substantive testing.

### Proprietary Fund Types

**13.40** Proprietary funds normally have the same internal accounting control concerns as all other funds of the reporting entity. However, the following areas frequently require special consideration.

**13.41 *Cash.*** The cash receipts and collection methods for proprietary funds are often different than those for governmental funds. The auditor should obtain an understanding of the internal control structure and assess control risk in areas such as public transportation fare-box collections, parking meter collections, lottery revenues, and student registrations.

**13.42 *Quasi-Autonomous Component Units.*** Many enterprise operations are conducted by quasi-autonomous component units operating separately from the sponsoring government. Accordingly, the internal control structure of enterprise funds frequently will require separate consideration from that of the sponsoring governmental unit.

**13.43 *Utility Billings.*** Internal control systems should provide reasonable assurance that customers have meters, that meters are read, that unusual or illogical readings are investigated, and that the aggregate use indicated by the reading of individual meters is reconcilable to the total use for the system.

### Audit Procedures

**13.44 *Rate-Setting and Billing Procedures.*** The auditor should consider any applicable regulatory rate-setting documents and the data supporting compliance with those regulations. The auditor should also determine whether the rates established are billed consistently and whether rate changes are incorporated into the billing system on a timely basis.

**13.45 *Contributions and Grants.*** The auditor should review grant and contract documents to determine any restrictions or compliance requirements and determine the amount of any noncompliance liability. Noncompliance may require the refund of all or a part of the grant.

## Chapter 14

# Fiduciary Funds

### Introduction

**14.01** The fiduciary fund type is used to account for assets held by a governmental unit in a trustee or safekeeping capacity, or as an agent for third-party individuals, private organizations, other governmental units, and/or other funds or component units of the financial reporting entity. Fiduciary funds, as defined in GASB Cod. sec. 1300, include *expendable trust funds*, *nonexpendable trust funds*, *pension trust funds*, and *agency funds*.

### Nature of Transactions

**14.02** Transactions may differ substantially between fiduciary fund types. Accordingly, each is discussed separately.

### Expendable Trust Funds

**14.03** Expendable trust funds are used to account for fiduciary relationships in which both the trust principal (corpus) and earnings thereon may be expended for the purposes of the trust. A variety of expendable trust funds are found in practice.

### Nonexpendable Trust Funds

**14.04** Nonexpendable trust funds are commonly used to account for fiduciary relationships in which the trust principal (corpus) may not be expended but must be kept intact, that is, the capital must be maintained. The earnings are sometimes nonexpendable, but often are expendable. Nonexpendable trust funds are often required, for example, when a state or local government receives gifts or bequests to maintain cemeteries, landmark buildings, or other structures in perpetuity.

### Pension Trust Funds

**14.05** Pension trust funds are used to account for activities related to public employee retirement systems (PERS), which are administered by the financial reporting entity. Some state and local governmental units manage multiple-employer PERS for component units or other governmental units. The employees of some governmental units are covered by PERS administered by other governmental units; for example, teachers in a particular school district are covered by a state PERS established for the benefit of substantially all teachers employed in the state.

### Agency Funds

**14.06** Agency funds are used to account for fiduciary relationships involving only custodial or modest management responsibilities. They report assets received for, and disbursed to, other governmental units or private sector organizations or groups. Examples of the use of an agency fund include a local government that collects fines for a state or collects sales taxes levied by another unit of government that are redistributed to such other units of government, student activity funds in school districts, or assets held by courts

pending disbursements to beneficiaries. Governments that utilize governmental funds in their financial statements are required (GASB Cod. sec. D25) to display IRC sec. 457 deferred compensation plan balances in an agency fund regardless of whether the plan assets are held by the government or a governmental or nongovernmental third party. GASB Cod. sec. S40.119 requires the use of an agency fund to account for the special assessment debt service transactions and balances currently due when a government is administering special assessment capital improvement projects, but is not obligated in any manner for the special assessment debt.

**14.07** The historical practice of using agency funds to account for payroll withholdings is discouraged because such transactions can be accounted for adequately in originating funds. In the interest of maintaining the fewest number of funds possible, transactions that can be accounted for as liabilities of a specific fund (for example, payroll withholding for general fund employees) may be so recorded.

## Accounting and Auditing Considerations

### Expendable/Nonexpendable Trust Funds

**14.08** Expendable trust funds are accounted for in essentially the same manner as governmental funds. Nonexpendable trust funds are accounted for in essentially the same manner as proprietary funds.

### Pension Trust Funds

**14.09** Pension trust funds are maintained on the accrual basis of accounting. If a PERS meets the provisions of GASB Cod. sec. 2100, the PERS is included in the governmental entity's financial statements. See also GASB Cod. sec. 2100.118 and .140 concerning the reporting of fiduciary funds and PERS.

**14.10** GASB Cod. sec. P20, Pe5, and Pe6 recognize the following three distinctly different alternative authoritative sources of acceptable pension accounting principles:

- a. NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, which essentially recognizes the principles in the 1968 GAAFR.
- b. NCGA Statement 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems and Pension Trust Funds*, as interpreted by NCGA Interpretation 8, *Certain Pension Matters*.
- c. FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*.

GASB Cod. sec. Pe6 contains disclosure requirements for pension trust funds. As of the date of this guide, GASB has issued three statements relating to pensions as follows: GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, effective for periods beginning after June 15, 1996; GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered By Defined Benefit Pension Plans*, effective for periods beginning after June 15, 1996; and GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, effective for periods beginning after June 15, 1997.

### Agency Funds

**14.11** Agency funds are purely custodial (assets equal to liabilities) and, thus, do not report a fund equity balance or measure results of operations. Agency funds use the modified accrual basis of accounting.



## Deferred Compensation Plans

**14.12** IRC sec. 457 authorizes certain state and local governmental units to provide deferred compensation plans for their employees. GASB Cod. sec. D25 provides accounting and reporting guidance for deferred compensation plans. Investments are generally recorded at market.

## Financial Statement Presentation and Disclosure

### Summary of Significant Accounting Policies

**14.13** Significant accounting policies to be disclosed include the basis of accounting for each of the fiduciary fund types, a description of the funds in use, the carrying basis of investments, and an explanation of any reservations of fund balance.

### Pension Plan Disclosures

**14.14** Pension plan disclosures are covered by GASB Cod. secs. P20 and Pe6. For pension trust funds included in the financial statements of an employer, certain ten-year required supplementary information (RSI) is also required to be included in the GPFS following the footnotes, unless it is included in a separately issued financial report of the pension trust fund. If it is included in a separately issued report, reference to the availability of the RSI can be made therein. As of the date of this guide, the GASB has issued GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, which is effective for periods beginning after June 15, 1996.

### Agency Fund Presentation

**14.15** Agency funds should be accounted for on the modified accrual basis. They are purely custodial (assets equal liabilities) and thus do not involve the measurement of results of operations. Neither revenues nor expenditures are recognized in agency funds. The year's activity is shown in a combined statement of changes in assets and liabilities—all agency funds—that presents changes in all the assets and liabilities rather than in only cash transactions. At the GPFS level, this statement is not required, but the information may be presented in footnotes.

### Deferred Compensation Plan Disclosures

**14.16** GASB Cod. sec. D25 requires that employers using governmental fund accounting report the assets and liabilities of a deferred compensation plan adopted, under the provisions of IRC sec. 457, in an agency fund of the government that has legal access to the resources, regardless of whether the assets are held by the government employer, a PERS, a nongovernmental third party, or another government under a multiple jurisdiction plan. Disclosure requirements are set forth in GASB Cod. sec. D25.113.

### Assertions

**14.17** GASB Cod. sec. 1300 requires that the financial reporting applicable to fiduciary funds should parallel those of the governmental funds for expendable trust and agency funds and those of proprietary funds for nonexpendable and pension trust funds. Therefore, the specific audit objectives should also be parallel.

## Internal Control Structure and Auditing Considerations

**14.18** The audit objectives of fiduciary funds should parallel those of other funds using the accrual or modified accrual basis of accounting.

**14.19** Trust agreements or state and local statutes may impose special compliance requirements. In those circumstances, the auditor should obtain evidence of compliance with those requirements, which could have a direct and material effect on the financial statements. That is particularly important if noncompliance occurs and trust fund assets revert to residuary beneficiaries.

### Audit Procedures

**14.20** The auditor should become familiar with the various compliance and fiduciary responsibilities of the entity, as discussed in the previous paragraph. The principal area of audit concern is the potential for the existence of a liability because of a misuse of assets.

**14.21 *PERS Transactions.*** PERS are generally comparable to pension plans in the private sector, hence, audit objectives are similar. Audit procedures in governmental pension plans differ little in most areas from those of auditing private pension plans. For audit guidance, the auditor can refer to the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, which discusses those procedures. There are, however, some unique functions, aspects, and activities of PERS that require special attention.

**14.22 *PERS Legal Requirements.*** The auditor should consider whether investments meet applicable statutory requirements. The requirements are normally set forth in state statutes or local ordinances or resolutions. The Employee Retirement Income Security Act (ERISA) does not apply to state and local governments.

**14.23 *Pension Plan Administration.*** When auditing the PERS, the auditor should determine who holds the administrative responsibilities of establishing contribution level, authorizing payments, and reporting. Some plans are administered on a day-to-day basis by the sponsoring governmental entity, or by a plan administrator, an investment advisor, a bank trust department, an insurance company, or a combination thereof. The auditor should determine who has fiduciary responsibility for the plan and who is responsible for plan administration.

**14.24 *Income Allocation.*** Pension assets are sometimes combined with other assets of a governmental unit to enhance the investment return in a pooled investment account. If so, the auditor should consider whether investment income is allocated properly.

**14.25 *Actuarial Information.*** In evaluating actuarial information, the auditor may consider using the work of an actuary. In that connection, the auditor should consider the guidance of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). That pronouncement, among other things, requires the auditor to make appropriate tests of data provided to the actuary. If the government does not have current actuarial data, the auditor should consider whether he or she should express a qualified opinion or disclaim an opinion.

**14.26 *Participant Eligibility.*** The auditor should consider testing the application of participant eligibility rules and statutory requirements, and evaluating whether the rules are followed consistently.

**14.27 *Participant Vesting.*** Vesting in the plan is subject to statutory requirements. The auditor should test vesting computations for compliance, and proper reporting and disclosure.

**14.28 *Data Verification.*** Governments that participate in a pension plan administered by another governmental unit often experience difficulty in obtaining needed pension data. Two standard actuary confirmation letters on disclosures of pension information by PERS and state and local governmental employers are available from the AICPA. If the minimum information necessary to apply GASB Cod. secs. P20, Pe5, and Pe6 is not available, the auditor should consider whether it is necessary to express a qualified or adverse opinion.

**Part IV**  
**Other Governmental Audit Engagements**

## Chapter 15

# *Special Governmental Units*

### Introduction

**15.01** Special governmental units usually provide single special-purpose services, in contrast with general governmental units that provide broad ranges of services. School districts represent the largest number of special governmental units; other special governmental units are usually referred to as authorities, agencies, or special districts. Such units are formed to provide a variety of services and may include the following:

- Airports
- Colleges and universities
- Economic development boards
- Fire protection districts
- Forest preserve districts
- Hospitals
- Housing authorities
- Indian tribes
- Industrial development authorities
- Libraries
- Mosquito abatement districts
- Park districts
- Parking authorities
- Pension plans
- Port authorities
- Public building authorities
- Public health districts
- Risk pools
- River conservancy districts
- Road and bridge authorities
- Sanitation districts
- Soil and water conservation, or management districts
- Transportation authorities
- Utilities
- Water authorities

**15.02** Depending on its organizational, reporting, and financial relationships and characteristics, a special governmental unit may be considered to be either a primary government, stand-alone government, or a component unit of a reporting entity. In the last case, the unit may elect or be required to issue separate financial statements. The accounting, financial reporting, and auditing considerations described in the preceding chapters, though applicable to general governmental units, are, in most cases, also applicable to either kind of special governmental unit. This chapter provides additional guidance for situations that the auditor may encounter in auditing special governmental units.

## Applicability of Other Audit and Accounting Guides

**15.03** A special governmental unit may be subject to the audit guidance provided in other audit and accounting guides. Audit guidance in other guides may apply to the following entities frequently operated by governments:

- Providers of health care services
- Colleges and universities
- Certain nonprofit activities
- Employee benefit plans
- Voluntary health and welfare organizations
- Property and liability insurance companies

## Accounting Considerations

### General Principles

**15.04** In planning the audit of a special governmental unit, the measurement focus of the governmental unit needs to be determined. The scope of activities in which the special governmental unit participates must also be considered.

**15.05** GASB Cod. secs. 1100.103 and 1300.104 describe the activities that are generally accounted for in each fund type. If the special governmental unit is involved in several distinguishable activities, and the flow of financial resources is the most appropriate measurement focus, it usually will be appropriate to present the unit's operations by using several funds and following the basis of accounting used by governmental funds. If the focus of the special governmental unit is to measure the costs of operations of the organization using the economic resources measurement focus, the proprietary fund model usually should be followed. However, in practice, it is often difficult to determine whether the proprietary model should be used, so judgment may be required. In some instances, the activities of the special governmental unit will be varied, and certain of its activities should be accounted for using each of the models.

**15.06 *Primary or Stand-Alone Governments.*** All primary and stand-alone governments should prepare financial statements for use by their governing boards, constituencies, creditors, and others. GASB Cod. sec. 2100 provides criteria to determine whether a unit is a primary or stand-alone government or, instead, a component unit that should be included in the financial statements of a financial reporting entity.

**15.07 *Component Units Reporting Separately.*** GASB Cod. sec. 2600.128 does not prohibit a component unit of a financial reporting entity from issuing separate financial reports. Separately issued financial reports are often issued, particularly if the financial statements are to be used in official statements for the sale of general obligation bonds, revenue bonds, or other debt of the component unit. The identity of the component unit, the fact that it is a component unit, and its relationship with the primary government should be disclosed in a footnote to the financial statements. The independent auditors' report should also disclose, appropriately, that the entity is a component unit of a financial reporting entity.

**15.08 *Joint Ventures.*** GASB Cod. sec. J50.102 defines a joint venture as a legal entity or other organization that results from a contractual arrangement and that is owned, operated, or governed by two or more participants as

a separate and specific activity subject to joint control, in which the participants retain (a) an ongoing financial interest, or (b) an ongoing financial responsibility. Ongoing financial interest and ongoing financial responsibility are discussed further in GASB Cod. sec. J50.103 and .104. Examples of joint ventures include, but are not limited to, regional transportation authorities, water treatment plants, solid waste facilities, airports, and libraries.

**15.09** GASB Cod. sec. J50 discusses accounting for a joint venture. For financial reporting purposes, there are two types of joint ventures: (a) joint ventures whose participants have equity interests and (b) joint ventures whose participants do not have equity interests. If the government has an equity interest in the joint venture, that equity interest should be reported as an asset of the fund that has the equity interest or reported in the GFAAG.

**15.10** Generally, for proprietary funds, an *investment in joint venture* account reported in a proprietary fund should report the participating government's equity interest calculated in accordance with the joint venture agreement. If the joint venture agreement provides for the participating government to share in the operating results of the joint venture, the equity interest should be adjusted for the participant's share of the joint venture's net income or loss, regardless of whether the amount is actually remitted. The equity interest should be reported in the proprietary fund's balance sheet as a single amount, and the fund's share of the joint venture's net income or loss should be reported in its operating statement as a single amount.

**15.11** Since the equity interest of a governmental fund in a joint venture generally represents equity primarily in capital assets and otherwise does not meet the definition of a financial resource, it is inappropriate to report the entire *net investment in joint venture* as an asset in a governmental fund. All or a portion of the equity interest should be reported in the GFAAG. The amount that should be reported in the GFAAG is the total equity interest adjusted for any portion of the equity interest that is included in the balance sheet of a governmental fund.

**15.12** The measurement focus and basis of accounting used by the joint venture are dependent on the flow of resources that are to be measured by the joint venture, regardless of what fund type the investor in the joint venture is. It may be appropriate, therefore, for a joint venture to use the flow of economic resources measurement focus, even though the investor in the joint venture is a fund that uses the flow of financial resources measurement focus.

## Special Governmental Units

**15.13 *Hospitals.*** Hospitals and other providers of health care services generally should be reported as enterprise funds following GASB Cod. secs. H50 and H55, as discussed in chapter 13, "Proprietary Fund Types."

**15.14 *Colleges and Universities.*** Colleges and universities should follow either the AICPA college guide model or the governmental model of accounting and financial reporting. (See GASB Cod. sec. Co5.) The notes to separately issued financial statements should disclose the relationship to a financial reporting entity and the accounting policies followed. If the AICPA college guide model is followed, all disclosures normally included in governmental financial statements should be made. In particular, disclosures concerning deposits with financial institutions, investments, and repurchase agreements and disclosures regarding public employee retirement systems would be appli-

cable. GASB Cod. sec. 2600 discusses how component units, including colleges and universities, should be presented in the financial statements of a financial reporting entity.

**15.15 School Districts.** School districts are the most frequently encountered special units. In some states, school districts operate as an integral part of a local governmental entity; but in others, school districts are primary governments or stand-alone governments. School districts may or may not have common boundaries with a political subdivision. Regardless of whether school districts are component units of a financial reporting entity, joint ventures of several reporting entities (such as consolidated districts), or meet the definition in GASB Cod. sec. 2100 as separate reporting entities, many school districts prepare separate financial statements in order to accomplish one of the following:

- Support state or federal aid applications.
- Report financial activities to parent, taxpayer, and citizen groups.
- Prepare a financial report for use in an official statement.

**15.16** There are several unique aspects of school districts, including the following:

- *Attendance Reporting.* Most school districts receive state aid on the basis of average daily membership (ADM) or average daily attendance (ADA). ADM and ADA data typically are determined at individual schools and reported to a central attendance unit. That unit prepares reports for state aid and, in many cases, for federal aid, such as impact aid. Attention should be directed to attendance reporting because of its importance to overall revenues of the school district. Incorrect attendance reporting can lead to the allocation of too much or too little aid.
- *Student Activity Funds.* Most school districts have cash funds or bank accounts at individual schools under the control of school principals (generally student-generated moneys). Attention should be directed to such funds, which are frequently excluded from the entity's normal accounting records and controls. Student activity funds usually are reported as agency funds of the district.
- *U.S. Department of Education Requirements.* The Department of Education has issued *Financial Accounting for Local and State School Systems*, which suggests a standardized chart of accounts for school districts. Financial reporting standards under, and applications for, federal grants generally require preparation according to the format suggested in that publication. The auditor should be familiar with *Financial Accounting for Local and State School Systems* or state-mandated variations of it.
- *School Lunch Programs.* Most school districts participate in the U.S. Department of Agriculture (USDA) free or price-reduced food programs. The auditor should be familiar with the USDA's regulations for such programs. USDA-donated commodities may also pose accounting and reporting problems; they are often reported as revenue when received and are recognized as an expenditure/expense when consumed.

**15.17** State departments of education, the Association of School Business Officials, and the National Association of College and University Business Officers (NACUBO) have issued additional nonauthoritative publications on



school system management, accounting, and financial reporting. Those may be helpful to the auditor and any that may be applicable should be identified and considered in developing the audit program.

**15.18 *Housing Authorities.*** Housing authorities provide shelter to lower income citizens and generally receive substantial capital and operating grants from the U.S. Department of Housing and Urban Development (HUD). The housing authorities provide the low-income housing by owning and managing housing developments, providing rent subsidies paid directly to the landlords, and/or providing vouchers to participants for rent subsidies that permit them to locate their own housing. Housing authorities also may finance low-interest mortgages for citizens and engage in urban renewal activities. Depending on state statutes or local ordinances, housing authorities generally operate as (a) departments of the sponsoring government, (b) component units of a financial reporting entity, or (c) stand-alone governments. Additionally, some housing authorities operate on a regional basis.

**15.19** If the criteria for proprietary funds are met, housing authorities should be reported as enterprise funds. Otherwise, they should be accounted for as governmental funds.

**15.20** The auditor should be familiar with the various housing grant programs in undertaking an audit of a public housing authority. Additionally, the auditor should consider confirming directly with HUD loans and other housing development and modernization debt to be assured that accrued interest and grant advances receivable have been recorded properly.

**15.21 *Financing Authorities.*** Many governmental units have established financing authorities to provide resources for specific capital projects or loans to special interest groups, such as organizations of veterans or farmers. Some financing authorities are established for the benefit of other governmental units or nonprofit organizations, for example, a government-supported hospital financing authority. In some cases, a for-profit business organization is the beneficiary of a financing authority. For example, an economic or industrial development authority that issues revenue bonds, the proceeds of which are used to provide for plant expansion, thereby increases a community's employment level and tax base. In other cases, a financing authority may be created by a governmental unit solely to finance internal capital projects, such as university dormitory construction. As a further example, mortgage financing authorities make low-interest mortgage loans available to citizens.

**15.22** Typically, a financing authority issues bonds to obtain funds for the construction of a facility that is then leased to another government or private sector organization. Lease payments received are used to service the bond principal and interest, and the ownership of the facility passes to the lessee when the bonds mature and are retired. In some cases, financing authorities develop a permanent capital base that is used for making loans and, occasionally, grants available to applicants.

**15.23** Authorities making loans available to citizens or citizen groups typically service bond principal and interest from loan repayments. Interest income in excess of interest expense typically finances administrative costs.

**15.24** Some financing authorities (such as hospitals, economic or industrial development) are created solely to lower the cost of borrowing for private sector entities constructing facilities within the jurisdiction served. Generally, the authority does not become directly involved in either the construction or the repayment of the debt. Debt service is usually administered by a financial institution as trustee. Practice supports that in such cases, the debt and related

capital lease receivable can be reported in the financial statements of the government or disclosed in the notes to the financial statements. Fees charged to the entities benefiting from the debt issuance and administrative expenses of the authority should be reported in the operating statement of the authority. GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*, provides certain disclosure requirements for conduit debt obligations (see paragraph 11.32 for a description of the disclosure requirements).

**15.25** Governmental units that create authorities to finance their capital projects usually execute lease contracts between the governmental units and the financing authorities. In accounting and reporting for lease agreements between governmental units and public authorities in the GPFS, first it must be determined whether the public authority is part of the governmental reporting entity for financial reporting purposes. If the authority is part of the financial reporting entity, a further determination needs to be made whether the authority's information is to be "blended" or shown "discretely." (See GASB Cod. sec. 2600.105.) When the authority is blended in the GPFS of the reporting entity, the criteria of FASB Statement No. 13, *Accounting for Leases*, do not apply and the public authority's debt and assets should be reported as a form of the primary government's debt and assets. For example, the leased general fixed assets would be reported in the GFAAG and related debt would be reported in the GLTDAG. The debt service activity of the public authority would be reported as a debt service activity of the primary government, and, if the public authority has a general fund, it would be included as a special revenue fund of the primary government.

**15.26** Capital lease arrangements between the primary government and public authorities reported as discretely presented component units (or between those component units) should be treated in the same manner as any other lease agreement of a state or local government. These agreements, therefore, should be considered long-term contracts for accounting and financial reporting purposes and afforded capital lease treatment if they meet the criteria of GASB Cod. sec. L20 and FASB Statement No. 13, *Accounting for Leases*. However, related receivables and payables should not be combined with other amounts due to or from component units, or with capital lease receivables and payables with organizations outside of the reporting entity. To avoid the double counting of assets and liabilities resulting from capital lease arrangements, eliminations may be made in accordance with GASB Cod. sec. 2200.112. For additional guidance on accounting and financial reporting for lease transactions, refer to GASB Cod. sec. L20 and chapter 10, "Capital Expenditures and Related Fund and Account Group Activity," of this guide.

**15.27 Transportation Systems.** Transportation systems may operate either as independent regional authorities, as joint ventures of the participating governments, or as component units of a financial reporting entity. Most transportation systems are accounted for as enterprise funds. (See GASB Cod. sec. 1300.104b(1).)

**15.28** Most public transportation systems, because of low rates or low ridership, seek outside contributions to finance facilities, equipment, and operating expenses. Net income, nevertheless, should include charges for depreciation on assets acquired from contributions in the form of capital grants in support of construction as well as those acquired from internal resources. Although depreciation expense on all assets is included in the statement of revenues and expenses to determine the net income or loss resulting from the operation of the system, the amount applicable to assets acquired from capital grants may be closed to the related contributed capital account rather than to retained earnings as in GASB Cod. sec. G60.116.

**15.29 Utilities.** Utilities generally should be accounted for through proprietary funds following GASB Cod. sec. Ut5. GAAP for utilities are generally those applicable to similar businesses in the private sector, as defined in GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*; the measurement focus is on determination of net income, financial position, and cash flows. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, may offer guidance in preparing GPFS for utilities that provide rate-regulated services and meet certain other criteria.

**15.30 Indian Tribes.** The federal government considers the various recognized Indian tribes as if they are states. Therefore, Indian tribes are usually accounted for as primary government or stand-alone governments. Financial statements for Indian tribes generally will include all the various fund types found in GPFS for other general-purpose governmental units.

## Chapter 16

### ***State Governments***

#### **Introduction**

**16.01** Although the matters discussed in the previous chapters generally apply to both state and local governments, a number of considerations are unique to state governments. Generally, state governments are large operations, some as large and diverse as the largest private sector entities. Distinguishing aspects of state governments that create special auditing considerations include the following:

- Reporting entity definition
- Independence of external auditors
- Joint audits
- Audits of component units
- Jurisdictional concerns
- Aid to local governments
- Pass-through grant programs
- Medicaid
- Lotteries
- Escheat property

Although these areas may also be of concern in audits of local governments, they are more commonly associated with state governments.

#### **Nature of States**

**16.02** State governments differ from local governmental units because they have sovereign power. The powers of states are limited by their individual constitutions and the powers granted exclusively to the federal government by the Constitution of the United States and the rights guaranteed to citizens by amendments to that constitution. States can enact, repeal, and modify statutes relating to the conduct of the economic, political, social, and individual activities subject to those limitations. All other governing bodies within the state exist as consequences of general or specific authorizations from the state government and are accorded only those powers provided for in such authorizations. State governments have implicit power, while subordinate governments created by states generally are limited to the powers expressly provided to them by the state or not expressly reserved for the state and, in some cases, not expressly prohibited.

**16.03** To meet the varying needs of citizens, states have established a variety of forms of state agencies and departments, regional governments, local governments, and special units of government. The extent and nature of those organizations affect the structure of the state financial reporting entity and, thus, the audit approach.

**16.04** To address the problems inherent in the variety of organizational structures, most states have established accountability centers, usually under the control of state comptrollers or treasurers. Such accountability centers do

not normally maintain accountability for all the component units of the state oversight entities. Rather, such centers are often limited to responsibility for the funds and activities of the states from which appropriations are made to departments and agencies. Other component units (such as public benefit corporations and authorities) in many instances maintain their own accounts and manage their own financial affairs, either with or without direct oversight from the accountability centers.

## Accounting Considerations

**16.05** All GASB pronouncements are applicable to state government financial statements. Nevertheless, state-mandated accounting and reporting requirements may extend beyond GAAP. Such requirements generally come from statutes, and their existence and specifics should be ascertained and confirmed by discussions with representatives of the states' attorneys general, treasurers, comptrollers, and auditors. For example, certain additional financial summaries may be mandated by state statutes.

## Auditing Considerations

**16.06** In addition to the issues discussed in the previous chapters, those addressed in the following sections should be considered in conducting audits of state governments.

### Reporting Entity Definition

**16.07** Determining the state financial reporting entity is often difficult because of the diversity of state component units and the numerous, nearly autonomous, component units, such as public benefit corporations, financially independent entities, and decentralized accounting systems. Even greater complexity may result if component units such as banks, railroads, hospitals, student financial loan programs, colleges, and universities are required to be included in the state financial reporting entity. States also tend to be involved in more joint ventures than local governments. Chapter 2, "The Financial Reporting Entity and Fund Structure," discusses considerations associated with defining the financial reporting entity and the related accounting and reporting under GASB Cod. sec. 2100.

### Independence of External Auditors

**16.08** While ensuring auditor independence at a local government may be difficult, ensuring independence at the state government level can be a major undertaking. The auditor independence requirements outlined in Rule 101 of the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), including Interpretation 101-10 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12), are quite extensive and must be reviewed in detail by all auditors working on a state engagement to determine compliance.

**16.09** Nonetheless, the auditor of the primary government is to be independent of the primary government and each component unit. Similarly, the auditor of a material component unit is to be independent of the component unit and the primary government.

### Joint Audits

**16.10** A joint audit occurs when two or more independent certified public accounting firms or a CPA firm and auditors from a government audit agency perform an audit. The resulting audit opinion is signed by both the government

audit agency and the CPA on joint letterhead. Joint audits are typically performed in two ways. In the first, the CPA and the government audit agency each may be responsible for auditing certain funds or entities (that is, component units) and the audit plans and working papers prepared by each are subject to review by the other. The alternative is to have personnel from the government audit agency and the CPA working together on all segments of the audit.

**16.11** Joint audits have many benefits, but also pose some unique problems. One problem that sometimes arises when a joint audit is performed (also present when the entire government audit is performed by the government audit agency) is a change in administration as a result of an election. In some cases, the auditor's last date of field work may fall within the outgoing government auditor's term and, therefore, the date of the auditor's report will be within the term of the outgoing government audit official. However, due to the amount of time required to finalize the financial statements and management letter, the signing of the joint audit report, management letter, and representation letter may not occur until after the incoming government audit official takes office.

**16.12** Since the incoming government audit official relies on the staff of the audit agency, whoever is in office when the audit report is completed should sign the report, even though the date of the opinion (last date of field work) may fall within the predecessor's term in office. Also, an interpretation of SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), entitled, *Management Representations When Current Management Was Not Present During the Period Under Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9333.05 and .06), discusses auditors' responsibilities for obtaining written representations in an audit engagement when current management was not present during the period under audit. In this situation, the Interpretation states that auditors should obtain written representations from current management on all periods covered in their report.

**16.13** Before entering into an agreement to perform a joint audit, the auditor must be satisfied that the CPA firm or government audit agency is independent and meets the appropriate professional standards. In meeting those standards, the CPA firm or government audit agency must be objective, professionally competent, and its work should have been peer reviewed by a recognized professional organization.

**16.14** In some cases, the government auditor may not be licensed to practice public accounting. In those situations, unless the government auditor has made provisions for these situations, the auditor may want to consult the state licensing board as to the potential consequences of jointly signing an audit report with a person who is not licensed to practice public accounting. (See chapter 21, "Single Audit Planning," paragraphs 21.15 through 21.20 for a discussion of joint audits and reliance on other auditors in conjunction with a single audit.)

## Audits of Component Units

**16.15** In a joint audit, the audit report is signed jointly and severally by the top official in the audit agency and the CPA firm. Therefore, if certain component units are audited by auditors other than those signing the primary government reports, it should be so noted in the report. Additionally, if one or more component units is audited by the CPA firm or the government audit

agency acting separately and not in connection with the joint audit of the primary government, that fact should be noted in the joint auditors' opinion.

### **Jurisdictional Concerns**

**16.16** State governments generally consist of three branches: executive, legislative, and judicial. Conflicts often exist among the branches regarding responsibilities and authority. As a practical matter, the auditor should be aware of such possible conflicts and consider whether the appropriate individuals are included in planning the audit, advised of audit progress, and provided opportunities to respond to draft reports.

**16.17** The legislative and judicial branches may maintain their own accounting systems. The auditor should be cognizant of the possibility that numerous accounting systems and various internal control structures are in use and should determine the extent to which such systems need to be evaluated for their effects, if any, on audit procedures.

### **Aid to Local Governments**

**16.18** States provide aid to local governments in the form of shared revenue, such as sales or highway taxes, grants and entitlements such as per capita aid, and school aid based on various formulas. Aid is distributed to local governments in many ways and often is based on a formula or eligibility criteria, or both.

**16.19** The auditor should consider whether the formula and eligibility criteria are applied properly and consider the internal control structure surrounding the awarding, monitoring, and payment functions. In addition, the auditor should evaluate the reasonableness of amounts recorded as payable to the local governments under the requirements of the various programs, especially if the local and state governmental units have different fiscal year ends. A number of programs operate on a reimbursement basis, and the state, therefore, will not know the actual amount owed until after year end, when local governments report reimbursable claims. Such amounts, therefore, frequently require management estimates.

**16.20** The auditor should determine that the amounts payable to the localities for shared revenues are properly accrued and reported in the financial statements. The auditor should consider reviewing disbursements subsequent to year end to gain assurance that all liabilities have been accrued. Additionally, the auditor should ascertain the existence of state receivables resulting from advance payments made to local governments or disallowed expenditures made by local governments.

### **Pass-Through Grant Programs**

**16.21** States often act as pass-through agents for federal funds allotted to states for programs administered by local governments and not-for-profit agencies. Many programs, such as Aid to Families with Dependent Children (AFDC) and education programs are financed in that manner.

**16.22** The auditor should consider whether the pass-through grant funds are administered in accordance with the compliance requirements specified by the federal government. Because states generally have a significant degree of

accountability (especially for monitoring subrecipients) for pass-through funds, the auditor should consider whether the state has procedures, commensurate with its degree of accountability, to determine that those funds are spent properly by local recipients. If the state is allowed to receive fees for administering the programs, the auditor should determine whether the state received the proper amounts.

**16.23** The federal government may disallow expenditures not in accordance with the assistance agreement; therefore, there may be a need to establish an allowance for refunds. The auditor should ensure that the potential need for an allowance for refunds is addressed by management and that the amounts reported, if any, are reasonable under the circumstances. The auditor also should ascertain whether the proper fund and account classifications of pass-through dollars are used, and whether the state has a liability, or a contingent liability, for not disbursing the funds in accordance with federal requirements. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance* (effective for financial statements for periods beginning after June 15, 1995), establishes accounting and financial reporting standards for pass-through grants.

## Medicaid

**16.24** Medicaid services may be administered by states and/or through local governments on behalf of the states. In either case, health care providers (for example, hospitals, physicians, nursing homes, pharmacies) are required to follow guidelines established by the state. Various methods and formulas are used to reimburse providers (and local governments) for services rendered, including the following:

- Hospitals and nursing homes may be reimbursed for the costs of rendering the services, with costs based on retrospective cost reports filed by the provider.
- Hospitals and other providers may be paid a predetermined (prospective) amount for each service rendered, based on the nature and/or complexity of the services.
- Nonhospital providers may be reimbursed based on the cost of the service (for example, physician office visit, prescription) up to a maximum cost per service.

At times, the state may make payments during the year to providers, particularly hospitals, based on interim reports. Settlements may be made at year end, based on audited cost reports. Those settlements can be either receivables from or payables to the providers.

**16.25** In many cases, providers, which may include local governments, may make claims for payments well after year end for services rendered before year end. Because of timing problems, the state may have to estimate the year-end liability to, or receivable from, providers. The auditor should consider whether payables and receivables, and related expenditures and revenues, are properly estimated and recorded at year end. Because these accruals are based on services rendered before year end, the auditor may have to use historical information to ascertain the reasonableness of the receivable or payable.

**16.26** The costs of Medicaid are shared between the state and federal governments. Such sharing varies by type of services rendered, which can vary by state. Furthermore, in some states, local governments also share in the costs. The auditor should become familiar with the types of services provided



and the cost-sharing arrangements within the state being audited and should ensure that the federal and state (and local, if applicable) shares are reported properly in the financial statements.

## Lotteries

**16.27** A growing number of states (and some local governments) are using lotteries to supplement revenues. Lottery revenue should be matched with proportionate shares of prize costs and other costs. Accordingly, both revenues and prize and other costs should be accounted for on an accrual basis, normally in an enterprise fund. To the extent that lottery revenue is legally dedicated for purposes other than prizes, the auditor should determine that applicable legal restrictions are adhered to and the resulting balances presented properly in the financial statements. Lottery prizes may be lump-sum payments, annuities, or both. The auditor should consider whether liabilities have been recorded properly for prizes won but not awarded and amounts to be awarded for games-in-progress at year end.

**16.28** Large prizes typically are paid over a period of years. The liability for such prizes is often financed with an annuity purchased from a private insurance company. If the purchased annuity is in the name of the prize winner, no liability or asset is recognized by the government because it has discharged the primary liability. However, consideration should be given to whether a contingent liability exists that should be disclosed in the financial statements. If an annuity in the name of the prize winner is not purchased, the liability and any assets specifically identified to meet that liability should be included in the financial statements of the governmental unit. The auditor should determine whether the liability has been recorded at its present value.

**16.29** A number of lottery games provide for a cumulative prize over time and a division of the total prize among many winners. In these situations, policies usually are established that provide for variable payout periods depending on the size of the amount awarded to each individual. For such games-in-progress at year end, it is necessary to record an estimate of the present value of anticipated prizes. The auditor should determine that the estimate of the present value of such anticipated prizes has been calculated and recorded properly.

**16.30** Lottery tickets are generally sold in stores and other designated localities throughout the state. Management should estimate the amount of receivables due from the sale locations along with an allowance for doubtful collections from sales agents to whom tickets have been consigned. The auditor should evaluate the reasonableness of those estimates.

## Escheat Property

**16.31** Because unclaimed property is submitted to the state, state governments are in a unique position. Escheat property (GASB Statement No. 21, *Accounting for Escheat Property*) should generally be reported in either an expendable trust fund or the fund to which the property ultimately escheats (the *ultimate fund*). Escheat property held for another government should be reported in an agency fund or in the fund in which the escheat property is otherwise reported, offset by a liability. Escheat revenue should be reduced and a fund liability reported to the extent that it is probable that escheat property will be reclaimed and paid to claimants. Payments to claimants should reduce the liability.

**16.32** If escheat property is initially reported in an expendable trust fund, amounts transferred to the ultimate fund should be reported as an operating transfer. If, as a result of the transfer, the remaining assets of the expendable trust fund are less than the liabilities of that fund, the difference should be reported as an *advance to* in the expendable trust fund and an *advance from* in the ultimate fund. If, however, the escheat assets of the expendable trust fund exceed the liabilities of that fund, the difference should be reported as fund balance.

## **Part V**

# **Concluding the Audit**

## Chapter 17

# Concluding the Audit

### Introduction

**17.01** At or near the end of audit field work, the auditor should perform certain additional procedures before issuing his or her report(s). This chapter addresses: (a) written representations from management, (b) disclosures of related-party transactions, (c) going-concern considerations, (d) commitments and contingencies, (e) subsequent events, and (f) analytical procedures.

### Written Representations From Management

**17.02** SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires the auditor to obtain written representations from management as a part of a GAAS audit. Such representation should be obtained from responsible client officials, including the chief executive and the chief financial officer. In a governmental audit, it is often desirable also to obtain the representation letters from other officials (for example, requesting the clerk to the legislative body to represent that the minutes are complete for all meetings held during the period). Further, the auditor should consider obtaining additional representations from management acknowledging the following:

- Management is responsible for the entity's compliance with laws and regulations.
- Management has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts.

See chapters 5, "Testing and Reporting on Compliance With Laws and Regulations," paragraph 5.25 and 6, "The Budget," paragraphs 6.29 and 6.30 for further discussion of representations from management.

**17.03** In addition to the representations ordinarily obtained in a GAAS audit, the auditor should consider obtaining representations about the following matters typically relevant in a governmental audit:

- The financial reporting entity's financial statements to be audited
- The inclusion of all component units, and the disclosure of all joint ventures and other related organizations
- The proper classification of funds and account groups
- The proper approval of reserves or designations of fund equities
- Compliance with laws and regulations, including budget laws or ordinances (see also, chapter 5, "Testing and Reporting on Compliance With Laws and Regulations," paragraph 5.25)
- Compliance with any tax or debt limits, including any related debt covenants
- Representations relative to GASB-required supplementary information
- Identification of all federal assistance programs, if applicable, and compliance with all related grant requirements (see Part VII, "Audits

of Federal Financial Assistance,” for additional representations to be obtained in a single-audit engagement)

**17.04** Paragraph 11 of SAS No. 19 (AICPA, *Professional Standards*, vol. 1, AU sec. 333.11) states that management’s refusal to furnish written representations is a limitation on the scope of the audit sufficient to preclude an unqualified opinion. The auditor of a governmental unit may encounter difficulty obtaining a representation letter if the responsible administrative officer is an elected official whose term differs from the governmental unit’s financial reporting year. For example, a newly elected official may not be willing, or able, to sign representations relating to a period prior to the beginning of his or her term of office. The official may be willing to sign the letter if he or she obtains supporting representations from other key officials who are responsible for financial matters during the period of the audit. An interpretation of SAS No. 19, *Client Representations*, entitled, *Management Representations When Current Management Was Not Present During the Period Under Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9333.05 and .06), discusses auditors’ responsibilities for obtaining written representations in an audit engagement when current management was not present during the period under audit. In this situation, the Interpretation states that auditors should obtain written representations from current management on all periods covered in their report (see chapters 3, “Planning the Audit,” paragraph 3.33, and 16, “State Governments,” paragraph 16.12).

## Disclosure of Related-Party Transactions

**17.05** In a governmental audit, related parties include members of the governing board, administrative boards or commissions, administrative officials and their immediate families, and affiliated or related governments that are not included as part of the financial reporting entity. Examples of related-party transactions in a governmental audit include buying supplies or services from a member of the governing body, selling assets owned by the governmental unit to a board member, and establishing a depository relationship with a family member of an administrative official (for example, financial officer).

**17.06** The primary accounting and auditing focus for related parties is adequacy of presentation and disclosure in the financial statements. GASB Cod. sec. 2300.107g requires disclosure of related party transactions for all governments. FASB Statement No. 57, *Related Party Disclosures*, which is applicable to proprietary funds, requires the disclosures below. In SAS No. 45, *Omnibus Statement on Auditing Standards*, “Related Parties” (AICPA, *Professional Standards*, vol. 1, AU sec. 334), the section entitled “Disclosure” (AICPA, *Professional Standards*, vol. 1, AU sec. 334.11 and .12), by reference to FASB Statement No. 57, requires the same disclosures.

- a. The nature of the relationship(s) involved
- b. A description of the transactions including transactions to which no amount or nominal amounts were ascribed and such other information deemed necessary to understand the effects of the transactions on the financial statements
- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

To meet the requirements of GASB Cod. sec. 2300.107, these disclosures could also be considered for governmental funds.

### Audit Procedures

**17.07** To determine the adequacy of presentation and disclosure of related-party transactions, audit procedures are applied throughout the audit. (See AICPA, *Professional Standards*, vol. 1, AU sec. 334.04—.06.) During audit planning, the auditor should identify known related parties and transactions, and update information from previous audits. At the end of the audit, the auditor should consider whether the results of procedures applied during the audit indicated the existence of related-party transactions that require disclosure.

### Going Concern Considerations

**17.08** SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341) provides guidance on the auditor's evaluation of whether there is substantial doubt about the entity's ability to continue as a going concern. Ordinarily, financial statements of a governmental unit are prepared based on the assumption that the reporting entity will continue as a going concern. SAS No. 59 relates going concern to the entity's ability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

**17.09** Many auditors have held the opinion that governmental units are not subject to the factors that might threaten the future existence of a business enterprise. That is largely attributed to the assumed power of governments to assess and levy taxes (and other charges) sufficient to finance operations and to service long-term and short-term debts. However, the ability to generate revenues, although unlimited by law, can actually be limited by the incomes and resources of taxpayers. Also, in recent years, governments have experienced instances in which local taxpayer initiatives have been enacted limiting governmental units' taxing powers. Recent economic events and developments have also raised questions about the ability of certain governments to sustain operations.

**17.10** Examples of conditions or events that may indicate substantial doubt about a governmental entity's ability to continue as a going concern are as follows:

- Extremely high estimated liability for incurred-but-not-reported (IBNR) claims in areas not insured
- Accelerating costs on construction and similar long-term projects disproportionate to economic feasibility
- Burdensome pension plan liabilities combined with shrinking populations and diminishing revenues
- Potential for large tax refunds as a result of taxpayers' challenges, reassessments, and large numbers of taxpayers relocating out of the unit's jurisdiction
- Declining tax base
- Unwillingness of senior governments to continue funding programs at existing levels
- Large investment losses
- Bond rating lowered below investment grade
- Major disaster such as earthquake, flood, or fire

- Tax rate at or near the legal limit
- Excessive use of short-term borrowing to reduce cash shortages
- Long-term borrowing to eliminate deficit or to meet current operating needs

**17.11** Other factors to be considered include whether federal, state, or other local governments have a legal or moral responsibility to subsidize or otherwise provide financial support to a distressed unit of government. The auditor should consider those areas in evaluating the likelihood of default on debt (for example, revenues less than originally forecasted for repayment of revenue bonds), the inability to meet pension costs or other obligations, the inability of one fund to continue to support the activities or operations of another fund that is incurring large deficits, or the inability to financially support present operating levels.

**17.12** If, having considered the guidance in paragraphs 5 through 9 of SAS No. 59 (AICPA, *Professional Standards*, vol. 1, AU sec. 341.05—.09), the auditor concludes that there is substantial doubt about the ability of the governmental unit to continue as a going concern, the auditor should consider the possible effects on the financial statements and the adequacy of the disclosures in the financial statements and include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion in accordance with paragraphs 12 through 16 of SAS No. 59, as amended by SAS No. 77, *Amendments to SAS No. 22, Planning and Supervision, No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 341.12—.16).

## Audit Procedures

**17.13** The auditor should evaluate whether conditions or events were noted during the audit up to the date of the auditor's report that indicate there could be substantial doubt about the governmental unit's ability to continue as a going concern. The following are examples of procedures that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading minutes of meetings of the governing board or any other administrative board with management oversight
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

## Commitments and Contingencies

**17.14** The auditor should consider whether the existence of any commitments or contingencies require recording or disclosure in the financial statements. Commitments include contractual obligations for a future expenditure/expense, and are usually long-term contractual obligations with suppliers for future purchases at specified prices and sometimes at specified quantities. Disclosure of commitments under unconditional purchase obligations associated with suppliers' financing, whether or not reported in the balance sheet; the terms of the commitments; and provision made for any material losses expected to be sustained should be considered.

**17.15** Loss contingencies are existing conditions that may create a legal obligation in the future but that arise from past transactions or events. GASB Cod. sec. C50.110 requires accrual of loss contingencies if under the following circumstances:

- Information available *prior* to issuance of the financial statements indicates that it is *probable* that an asset has been impaired or a liability incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

If no accrual is made for a loss contingency because one or both of the preceding conditions are not met, but there is a *reasonable possibility* that a loss or an additional loss may have been incurred, the financial statements should disclose the nature of the contingency and an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

**17.16** For governmental funds, the total amount of the loss contingency that meets the criteria is accrued. The current portion is recorded as a fund liability if the amount normally would be liquidated with expendable available financial resources. Any remaining liability is recorded in the GLTDAG. In proprietary funds, the expense and the liability are recorded in the fund.

**17.17** Examples of commitments and contingencies often found in a governmental unit are as follows:

- Sale of assets and agreements to repurchase assets previously sold
- Guarantees or endorsements
- Long-term leases with required fixed payments for several years
- Projects that require annual payments entered into with other governmental units
- Commitments to purchase large quantities of materials or services
- Commitments related to the construction, expansion, or rehabilitation of facilities
- Litigation, claims, and assessments pending, threatened, or unasserted at balance-sheet date
- Proposed or recognized tax refund claims of taxpayers
- Possible claims for disallowed costs or expenditures incurred under a federal financial assistance program
- Contingencies related to risk financing and related insurance activities (see paragraphs 9.13 and 9.14 herein)

## Audit Procedures

**17.18** Some commitments or contingencies are discovered as a result of procedures applied to specific financial statement elements for other audit objectives. Other procedures that may be employed to identify commitments and contingencies include the following:

- Inquiring of responsible officials about the possibility of unrecorded commitments or contingencies
- Reading the minutes of meetings of the governing body or finance boards
- Reading the contracts, loan agreements, leases, and similar documents
- Reviewing the current and past years' reports from grantor agencies
- Analyzing legal expenses and inspecting invoices from lawyers
- Inquiring of legal counsel



**17.19** Occasionally, a government may not retain an inside or outside lawyer and may not have consulted a lawyer during the period about litigation, claims, or assessments. In those cases, the auditor must rely on other audit procedures to disclose the existence of litigation, claims, and assessments, in addition to making inquiries of client officials.

## Subsequent Events

**17.20** Subsequent events are those that take place after the balance-sheet date but prior to the issuance of the financial statements and auditor's report. (For a discussion, see SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560).) They consist of events or transactions that—

- Provide additional evidence about conditions that existed at the balance-sheet date and affect the estimates inherent in preparing financial statements
- Did not exist at the balance-sheet date but arose subsequent to the date, but nevertheless, are of such a nature that they should be disclosed to prevent the financial statements from being misleading

**17.21** Examples of subsequent events in a governmental audit include the settlement of a lawsuit in the subsequent period that was caused by an event taking place in the period being reported on, issuance or defeasance of bonds or other debt instruments, and loss of grant funding or notice of potential disallowances.

## Audit Procedures

**17.22** Subsequent events may be discovered as a result of audit procedures applied to specific financial statement elements for other audit objectives or through cutoff testing and assessment of asset or liability valuations. Procedures include—

- Reviewing subsequent collections of receivables or payment of expenditures/expenses.
- Inquiring of responsible administrative officials about the current status of material unresolved issues at the balance-sheet date.
- Reading any financial reports prepared since the balance-sheet date.
- Reading minutes of meetings the governing board, or any other administrative board with management oversight, held subsequent to the balance-sheet date.
- Reading subsequent years' budgets (capital and operating).

## Analytical Procedures

**17.23** Analytical procedures are used as an overall review of the financial information in the final review stage of the audit. The objective of analytical procedures used in the overall review stage is to assist the auditor in assessing the conclusions reached and evaluating the overall financial statement presentation.

**17.24** The overall review generally would include reading the financial statements and notes and considering (a) the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit, and (b) unusual or unexpected balances or relation-

ships that were not previously identified. Results of an overall review may indicate that additional evidence may be needed. Paragraphs 4 and 22 of SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.04 and .22), provides guidance on the use of analytical procedures in the final review stage.

**Part VI**  
**Auditor's Reports**

## Chapter 18

# ***Auditor's Reports on Basic or General-Purpose Financial Statements***

### **Introduction**

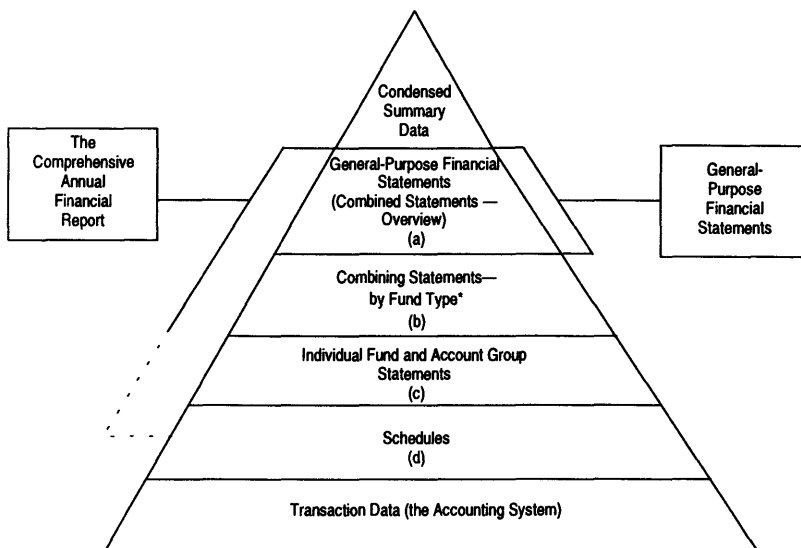
**18.01** Many governmental units are required by law to publish annual financial reports. An increasing number of such reports contain financial statements that have been audited by independent auditors. The governmental unit management is responsible for the contents of the financial statements, including the notes. The independent auditor's responsibility is to report on whether the financial statements are presented fairly in accordance with GAAP. The type of report the independent auditor issues depends on the contents of the financial statements and on the scope and results of the audit. (See appendix A, "Illustrative Auditor's Reports.")

### **Levels of Financial Reporting**

**18.02** GASB Cod. sec. 1900.117 illustrates a financial-reporting *pyramid* (included here as exhibit 18.1, "The Financial Reporting Pyramid"), which characterizes the financial reports of governmental units. The pyramid approach to governmental financial statements has implications for the nature and scope of financial audits.

## Exhibit 18.1

## The Financial Reporting Pyramid



—— Required  
 - - - May be necessary

( ) Refers to "the financial-reporting pyramid" discussion in paragraph 18.03.  
 Source: GASB Cod. sec. 1900.117.

\* GASB Cod. sec. 2600 adds "and for discretely presented component units."

**18.03** Exhibit 18.1 illustrates the levels of the pyramid. These levels are discussed in GASB Cod. sec. 1900.118 as follows:

- a. *General-Purpose Financial Statements (Combined Statements—Overview).* These basic financial statements provide a summary overview of the financial position and operating results of the reporting entity. They also serve as an introduction to the more detailed statements and schedules that follow. Separate columns should be used for each fund type and account group of the primary government. The statements should also include one or more separate columns to display the financial position and operating results of the discretely presented component units.
- b. *Combining Statements.*
  - **By Fund Type.** When a primary government (including its blended component units) has more than one fund of a given type (for example, special revenue funds), combining statements for all funds of that type should be presented in a columnar format. The total columns of these combining statements should agree with the amounts presented in the GPFS. (In some instances, disclosure sufficient to meet CAFR reporting objectives may be achieved at this level; in other cases, these statements “link” the GPFS and the individual fund statements.)
  - **For Discretely Presented Component Units.** When a financial reporting entity has more than one discretely presented component unit, the total columns of these combining statements should agree with the amounts presented in the GPFS. (Combining statements are not required if a governmental entity presents each component unit in a separate column in the GPFS.) Statements that present the underlying fund types of an individual discretely presented component unit are also required to be presented if the information is not available in separately issued financial statements of the component unit.
- c. *Individual Fund and Account Group Statements.* These statements present information on the individual funds and account groups of the primary government where (1) a primary government (including its blended component units) has only one fund of a specific type, or (2) detail to assure disclosure sufficient to meet CAFR reporting objectives is not presented in the combining statements. These statements may also be used to present budgetary data and prior-year comparative data for the funds and account groups of the primary government.
- d. *Schedules.* Schedules are used (1) to demonstrate finance-related legal and contractual compliance (for example, where bond indentures require specific data to be presented); (2) to present other information deemed useful (for example, combined and combining schedules that encompass more than one fund or account group, such as a Combined Schedule of Cash Receipts, Disbursements, and Balances—All Funds); and (3) to provide details of data summarized in the financial statements (for example, schedules of revenues, expenditures, transfers).

All four pyramid levels of detail may be required in some circumstances. On the other hand, adequate disclosure may require only one or two levels. Deter-

mination of the appropriate level of detail—and the distinction as to what is presented in a statement as opposed to a schedule—is a matter of professional judgment.

**18.04** Combined financial statements in governmental financial reporting are significantly different from those in commercial financial reporting. In the commercial area, combined financial statements generally are aggregated financial statements for two or more business enterprises that do not have a parent-subsidiary relationship. In the governmental area, combined financial statements show the respective fund types and account groups in side-by-side columns. Illustrations of combined financial statements are included in GASB Cod. sec. 2200.901-906.

**18.05** GASB Cod. sec. 1900.109 states that every governmental entity should prepare and publish a CAFR that includes all funds and account groups of the primary government and all discretely presented component units of the reporting entity. The CAFR contains introductory information, schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, and statistical data. The main components of the CAFR are—

- a. The GPFS (See paragraphs 18.08 through 18.10 herein.)
- b. Combining statements for the fund types of the primary government (including its blended component units). Combining statements should also be presented for the discretely presented component units.
- c. Individual fund statements and schedules for the funds of the primary government (including its blended component units).

**18.06** The GPFS are designed so that they may be lifted from the CAFR and issued separately. Such statements may be used for inclusion in official statements for securities offerings and for widespread distribution to users that require less detailed information about the governmental entity's finances than that which is contained in the CAFR. (The auditor's responsibilities when associated with financial statements included in official statements are discussed in chapter 19, "Association With Financial Statements Included in Official Statements.")

**18.07** As discussed in GASB Cod. sec. 2600, the GPFS and CAFR of a financial reporting entity should include the financial statements of component units. As discussed in chapter 2, "The Financial Reporting Entity and Fund Structure" the auditor should perform procedures to be assured that all of the financial reporting entity's component units are included. The auditor may examine ordinances, interview officials, and make other inquiries to evaluate whether there are component units that should be, but have not been, included in the reporting entity according to the provisions of GASB Cod. sec. 2100. Moreover, the auditor also should determine whether components that have been included have been audited and, if so, refer to SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543) and chapter 3, "Planning the Audit," of this guide for further guidance. If the component units have not been audited, it may be.

## Financial Statements

### General-Purpose Financial Statements (Combined Statements—Overview)

**18.08** GASB Cod. sec. 2200.136 states that the fund type and account group financial information included in the GPFS constitutes "fair presentation

in conformity with generally accepted accounting principles.” The following are the GPFS discussed and illustrated in GASB Cod. secs. 2200 and 2450:<sup>17</sup>

- a. Combined balance sheet—all fund types, account groups, and discretely presented component units
- b. Combined statement of revenues, expenditures, and changes in fund balances—all governmental fund types and discretely presented component units that use governmental fund accounting
- c. Combined statement of revenues, expenditures, and changes in fund balances—budget and actual—general and special revenue fund types (and similar governmental fund types of the primary government, including blended component units, for which annual budgets have been legally adopted)
- d. Combined statement of revenues, expenses, and changes in retained earnings (or equity)—all proprietary fund types and discretely presented component units that use proprietary fund accounting
- e. Combined statement of cash flows—all proprietary fund types and discretely presented component units that use proprietary fund accounting
- f. Notes to the financial statements
- g. Required supplementary information

Trust fund operations may be reported in items *b*, *d*, and *e* above, as appropriate or separately.

**18.09** The combined financial statements listed above should include all disclosures necessary for fair presentation in conformity with GAAP. GASB Cod. sec. 2300 provides guidance on disclosures.

**18.10** The GPFS may present total columns for the financial reporting entity as a whole. If a total column is presented, it should be captioned “Memorandum Only” because the total column is not comparable to consolidated financial statements. Any eliminations of interfund balances and transactions should be apparent from the headings in the statements or disclosed in the notes to the financial statements. If a total column for the reporting entity as a whole is presented, a total column for the primary government also should be presented and labeled “Memorandum Only.”

**18.11 *Budgetary Comparisons as Part of Financial Statements.*** GASB Cod. sec. 2400 requires that governmental financial reports include, as the minimum budget-basis presentation, comparisons of the appropriated budgets related to data for the general fund, all special revenue funds, and other governmental fund types (including blended component units) for which annual budgets have been adopted. Appropriated budgets are those adopted by either the legislative or governing board of the oversight unit and/or its related component units for their governmental fund types. Budgetary data for the discretely presented component units are not required to be presented in the reporting entity's combined statement of revenues, expenditures, and changes in fund balance—budget and actual.

**18.12** If annual budgets are adopted for some, but not all, funds of a particular governmental fund type, data should be presented only for those funds for which annual budgets have been adopted.

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<sup>17</sup> The combined financial statements may also contain financial statements for discretely presented component units that use the Industry Audit Guide *Audits of Colleges and Universities* (New York: AICPA, 1993).



**18.13** If the budget is prepared on a basis that differs from GAAP, GASB Cod. sec. 2400.104 requires the actual data to be presented on the budgetary basis in the combined statement of revenues, expenditures, and changes in fund balance—budget and actual, general and special revenue fund types. The nature of the reconciling items between GAAP and the budget basis should be disclosed in the notes to the financial statements as outlined in GASB Cod. sec. 2400.104. Accounting and reporting for encumbrances is a common example of such a reconciling item. Encumbrances outstanding at year-end should not be recognized as expenditures; GASB Cod. sec. 1700.129 generally requires them to be reported as reservations of fund balance or disclosed in the notes. Budgets, however, often treat encumbrances as expenditures. Additional guidance on budget-GAAP differences is provided in GASB Cod. sec. 2400.

**18.14 *Legal Program or Project Budgets Exceeding One Year in Length.*** Some governmental units control spending for particular programs or projects by adopting legal budgets that include more than one year's expected expenditures. For example, legally authorized budgets for capital projects are often adopted for the multiyear lives of the projects. Such budgets are not required to be presented in the GPFS because they are not annual budgets.

**18.15 *Legally Required Proprietary Fund Budgets.*** Although GAAP do not require the inclusion of budgetary comparisons for proprietary fund types, neither do they preclude them; some jurisdictions may require such presentations by law. Budgetary comparisons for proprietary funds may be presented as supplementary information or in the GPFS.

## Comprehensive Annual Financial Report

**18.16** In addition to the combined financial statements, a governmental unit also may issue combining, individual fund, and account group financial statements and supporting schedules, usually in the comprehensive annual financial report. The auditor may report on the combining and individual fund financial statements either by themselves or as supplementary financial information.

## Financial Statements of Component Units

**18.17** As described in GASB Cod. sec. 2600.128, although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government, such as a component unit, may serve as a nucleus for a reporting entity when it issues separate financial statements. The requirements of GASB Statement No. 14, *The Financial Reporting Entity*, should be applied in layers "from the bottom up." That is, each component unit layer should apply the definition and display provisions to its own component unit financial reports.

**18.18** As discussed in GASB Cod. sec. 2600, a governmental component unit may issue separate financial statements (GPFS or CAFR) as if it were a primary government. Separately issued financial statements of a component unit should acknowledge that it is a component unit of another government, for example, "Sample County School District, a component unit of Sample County." In addition, the notes to the component unit's financial statements should identify the primary government in whose financial reporting entity the component unit is included and describe the relationship with the primary government. However, financial statements that present only the financial data of the primary government should acknowledge that the financial state-

ments do not include the data of component units necessary for fair presentation in conformity with GAAP. (See Example A.4, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit," in appendix A.)

## Summary Financial Information

**18.19** Some governmental units have issued summarized statements that include, for example, some or all adjustments normally associated with commercial consolidated financial statements. The question of whether such summarized financial statements are useful is under study. Current accounting literature requires combined financial statements for fair presentation in conformity with GAAP and considers summarized financial statements supplementary data.

**18.20** GASB Cod. sec. 2700.104 states, in part:

Some governmental units have for many years published highly condensed summary financial data, usually as "popular" reports directed primarily to citizens. . . . More recently, several professional association committees and individuals have undertaken research and experimentation directed toward the design of highly condensed summary financial statements for governmental units. Such research and experimentation is encouraged, but . . . such statements should supplement, rather than supplant, the comprehensive annual financial report (CAFR) and the separately issued general-purpose financial statements (GPFS). Further, the data in such highly condensed summary statements should be reconcilable with the combined, combining and individual fund and account group statements, and the reader of such statements should be referred to the CAFR and/or the separately issued GPFS of the governmental unit.

Governments have begun to issue popular reports, reports to citizens, condensed financial statements and summary reports that collectively are referred to as summary financial information. Summary financial information includes financial data derived from the GPFS, which are presented in some form of financial statement(s) along with accompanying footnotes. It does not include charts and graphs including financial information.

**18.21** SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*, vol. 1, AU sec. 552), provides guidance in reporting on condensed financial statements that are derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency. Because a governmental unit is not a public entity as defined under SAS No. 42 with respect to reporting on separately issued summary financial information, the provisions of SAS No. 42 do not apply to governmental units. Accordingly, the following paragraphs provide reporting guidance when an auditor of the GPFS is engaged to report on summary financial information issued by a state or local governmental unit in a document that refers to, but does not include, the GPFS.<sup>18</sup>

**18.22** Guidance on reporting on condensed financial statements and selected financial data that accompany the GPFS from which they were derived

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<sup>18</sup> This guidance applies to summary financial information of all state and local governmental entities, including public benefit corporations and authorities, public employee retirement systems, governmental utilities, governmental hospitals and other health care providers, and governmental colleges and universities.

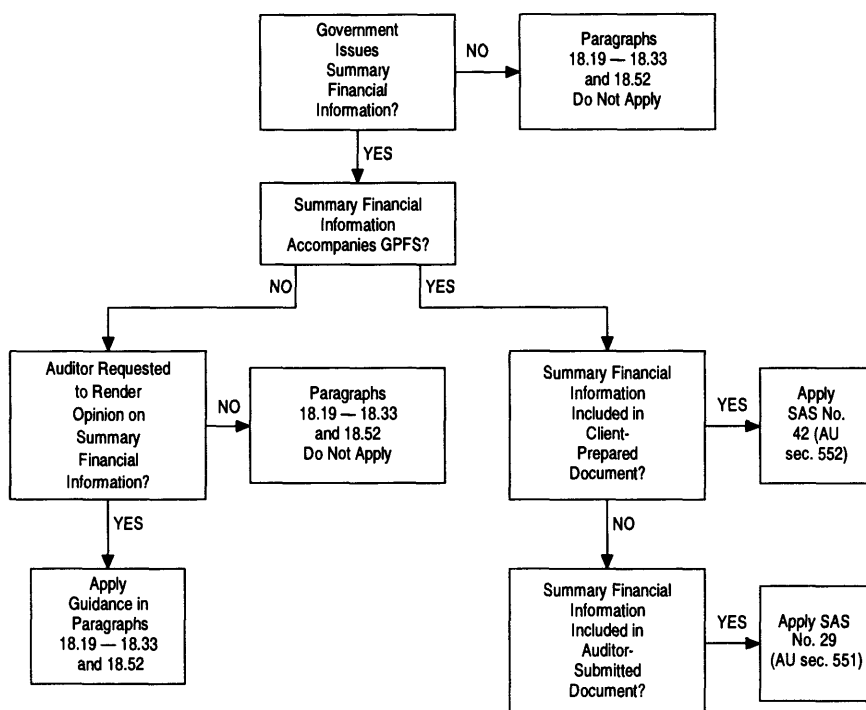
is found in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), and SAS No. 42.<sup>19</sup> The auditor reporting responsibility for the situations described in this paragraph and paragraph 18.21 is presented in the flowchart contained in exhibit 18.2, “Guidance for Reporting on Summary Financial Information.” This section does not apply to reporting on portions of a CAFR or GPFS such as a fund, fund type, or account group. The form and content of the data presented and the nature of the document in which the data are presented generally dictate the reporting guidance to be followed.

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<sup>19</sup> SAS No. 29 provides guidance on reporting on condensed financial statements or selected financial data that accompany audited financial statements in auditor-submitted documents. SAS No. 42 provides guidance on reporting in a client-prepared document on condensed financial statements or selected financial data derived from audited financial statements included in the client-prepared document.

## Exhibit 18.2

## Guidance for Reporting on Summary Financial Information



**18.23** In the absence of authoritative guidance on format and content, summary financial information often differs from financial statements prepared in accordance with GAAP as to:

- Principles of summarization or aggregation
- Fund structure
- Principles for eliminations
- Reporting budget and actual comparisons
- Inclusion of component units
- Note disclosures

Because of the lack of authoritative guidance on the format and content of summary financial information, the government should exercise discretion in the preparation of the financial information. However, the government should determine whether (a) the summary financial information, including the related notes, is informative of matters that may affect its use, understanding, and interpretation (for example, significant subsequent events, significant contingencies, or restrictions on resources), (b) the summary financial information is prepared on the same measurement focus and basis of accounting as the GPFS, (c) the summary financial information is classified, summarized, and presented in a reasonable manner, and (d) the summary financial information reflects the underlying transactions and events in a manner that presents the summarized data stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in summary financial information.

**18.24** When a government issues summary financial information based on the guidance provided in paragraph 18.23, the auditor should follow the guidance in paragraphs 18.26 through 18.32. If a government issues summary financial information that differs from the guidance provided in paragraph 18.23, the auditor should follow the guidance in paragraph 18.33.

**18.25** Summary financial information is presented in considerably less detail than that in GPFS, that are intended to present financial position, results of operations, and cash flows in conformity with GAAP. For this reason, it should be read in conjunction with the entity's most recent GPFS that include all the disclosures required by GAAP. Summary financial information is not the primary accountability document of the government. The auditor may only report on summary financial information if the government issues a CAFR or GPFS and the auditor has rendered an opinion on the CAFR or GPFS. In order to render an opinion on the summary financial information, the auditor should have obtained a sufficient audit base through the audit of the GPFS. Where more than one auditor has been involved in rendering an opinion on the GPFS, only the principal auditor should render the opinion on the summary financial information.

**18.26** Because summary financial information presents highlights of government activities during the year and does not constitute a fair presentation of financial position, results of operations, and cash flows in conformity with GAAP, an auditor should not report on summary financial information in the same manner as he or she reported on the GPFS from which they are derived. To do so might lead users to assume, erroneously, that the summary financial information is a fair presentation in accordance with GAAP. For the same reason, the summary financial information should be clearly marked as summary financial information.

**18.27** Because financial statement users may relate consolidated or condensed financial statements to GAAP, the summary financial information should

not be labeled as condensed financial information or consolidated financial statements.

**18.28** The auditor should consider whether the summary of significant accounting principles disclosed in the notes to the summary financial information discloses the method of aggregation used by the government to prepare the summary financial information. The auditor should also consider whether the notes disclose how the method of aggregation materially differs from the principles followed in preparing the GPFS. The explanation of the differences can be achieved through a formal reconciliation or narrative explanation. The availability of the CAFR or separately issued GPFS should also be disclosed in the notes to the summary financial information. In deciding the type of auditor's report to render, the auditor should consider whether the summary financial information is fairly presented in accordance with the method of aggregation described in the notes to the summary financial information. (See paragraph 18.33 for guidance when the summary financial information is prepared on a measurement focus and basis of accounting that differs from the GPFS.)

**18.29** The auditor should determine whether the summary financial information has been derived from the GPFS and can be reconciled to the GPFS. If the auditor determines that the summary financial information has not been derived from the GPFS, the auditor should follow the guidance in paragraph 18.33.

**18.30** The auditor's report on summary financial information should be based on his or her judgment as to whether (a) the summary financial information including the related notes, is informative of matters that may affect their use, understanding, and interpretation (for example, significant events occurring subsequent to the issuance of the GPFS, significant contingencies, or restrictions on resources), (b) the summary financial information is prepared on the same measurement focus and basis of accounting as the GPFS, (c) the summary financial information is classified, summarized, and presented in a reasonable manner, and (d) the summary financial information reflects the underlying transactions and events in a manner that presents the summarized data stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in summary financial information.

**18.31** When the summary financial information and independent auditor's report thereon are presented in a document with other information, the auditor should consider the guidance in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550). SAS No. 8 provides guidance on the auditor's responsibility with respect to information included in a document that is not identified in the audit report. The auditor should be aware of references to other information in the document that would give the perception that the auditor is associated with information other than that specified in the auditor's report on the summary financial information.

**18.32** If the auditor concludes that the summary financial information is not fairly stated in all material respects in relation to the GPFS from which it has been derived, the auditor should follow the guidance in paragraph 18.33. If the auditor concludes that the summary financial information is fairly stated in all material respects in relation to the GPFS from which it has been derived, the basic elements of the auditor's report on summary financial information should include the following (see appendix A, example A.27, "Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23."):

- a. A title that includes the word *independent*
- b. A statement that the auditor has audited the GPFS and a reference to the auditor's report on those financial statements, including the date of that report and a description of any modification of the standard report on the GPFS
- c. A statement that the accompanying summary financial information is not a presentation in conformity with GAAP, with a reference to the notes to the summary financial information describing the method of aggregation
- d. An opinion as to whether the information presented in the summary financial information is fairly stated in all material respects in relation to the GPFS from which it has been derived; the issuance of a qualified opinion on the GPFS does not preclude the auditor from issuing a report on the summary financial information as illustrated in appendix A, example A.27
- e. The manual or printed signature of the auditor's firm
- f. The date of the audit report on the summary financial information, which, unless significant subsequent events have occurred, should be the same as the date of the audit report rendered on the GPFS from which it was derived (Should a material event occur subsequent to the date of the audit report on the GPFS, the date on the audit report on the summary financial information should be dual dated for the subsequent event disclosed in the notes to the summary financial information.)

**18.33** If a government issues summary financial information in a manner inconsistent with the guidance provided in paragraph 18.23, for example, the measurement focus and basis of accounting differ from that of the GPFS, the auditor should express an adverse opinion on the summary financial information (a different measurement focus and basis of accounting would include changing from a modified accrual basis of accounting to a cash basis, recording depreciation on general fixed assets through the operating statement of a governmental fund type, etc.). In expressing an adverse opinion, the auditor should disclose in a separate explanatory paragraph preceding the opinion paragraph of his or her report (a) all of the substantive reasons for the adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on the financial positions and results of operations. If the effects are not reasonably determinable, the report should so state. See appendix A, example A.28, "Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23," and paragraphs 67 through 69 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.67-.69) and footnote 6 of SAS No. 42 (AICPA, *Professional Standards*, vol. 1, AU sec. 552.07, footnote 6).

## The Independent Auditor's Report

### General Concepts

**18.34** *Generally Accepted Accounting Principles.* The primary objective of an audit of a governmental unit's financial statements by an independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and, for its proprietary funds and nonexpendable trust funds, cash flows, in conformity with GAAP. As dis-

cussed in chapter 3, "Planning the Audit," the fund types and account groups are important elements of governmental financial statements and audit scope should be established and materiality evaluations should be applied at that level. Further, GPFS must present all applicable fund types and account groups in the governmental combined statement format to conform to GAAP.

**18.35 *Principal Auditor and Independence Issues.*** There are many situations in which more than one auditor is involved in auditing the components of a reporting entity. A discussion of principal auditor and independence responsibilities in such situations appears in chapter 3.

**18.36 *Reporting Other Financial Information Accompanying Basic Financial Statements.*** A financial report of a governmental unit may include a wide variety of financial information in addition to the basic financial statements. The types of information typically included are supplemental financial statements, schedules, and statistical data. The manner in which the auditor reports on the additional information depends on the scope of the auditor's examination, the nature of the additional information, and whether the information is included in a client-prepared or auditor-submitted document.

**18.37** If the additional information consists of combining or individual fund financial statements and related schedules, the auditor should report on such financial statements and schedules as discussed below. In an auditor-submitted document, the auditor also should report on any other data included in the financial report as discussed in SAS No. 29. If the auditor's report is included in a client-prepared financial report, the auditor should follow the guidance in SAS No. 8 with respect to statistical or other data that the auditor has not audited. (See also, chapter 19, "Association With Financial Statements Included in Official Statements.")

**18.38** The statistical section usually contains multiyear comparisons and other financial and nonfinancial information. The independent auditor normally considers the entire statistical section as unaudited and, accordingly, issues a disclaimer of opinion or assures that the statistical section is clearly identified as not covered by the auditor's report. In practice, the latter procedure is usually followed.

**18.39 *Prior Year Totals.*** The financial statements presented in GASB Cod. sec. 2200.901 include a column for prior-year totals. Footnote 27 to SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.74, footnote 27) discusses that situation and states that the continuing auditor need not report on such information.

## Auditor's Reports

**18.40** Many of the forms of reports that may be issued by the independent auditor are described in the following paragraphs.

**18.41 *General-Purpose Financial Statements.*** If the auditor is engaged to audit the GPFS of a governmental unit that presents only combined financial statements, the auditor should issue a report on the governmental unit's financial position, results of operations, and, if applicable, the cash flows of its proprietary fund types and nonexpendable trust funds. (See appendix A, example A.1, "Unqualified Opinion on General-Purpose Financial Statements.")

**18.42 *General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data.*** If the auditor is engaged to audit the GPFS and also submits combining and individ-



ual fund and account group financial statements as supplementary data, SAS No. 29 applies. Thus, the auditor's report should state whether the combining and individual fund and account group financial statements are stated fairly in all material respects in relation to the GPFS taken as a whole. (See appendix A, example A.2, "Unqualified Opinion on General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data.") In addition, the auditor should be satisfied that the combining and individual fund financial statements are suitably titled. As discussed above, the scope of the audit ordinarily includes the application of auditing procedures to individual fund and account group data, and the auditor is in a position to express an opinion on such accompanying information as provided by SAS No. 29.

**18.43** If the auditor is engaged to audit the combining and individual fund and account group financial statements in addition to the GPFS, the auditor's opinion addresses each presentation as a primary statement. Ordinarily, in such circumstances, the auditor will need to expand the auditing procedures applied to the combining and individual fund and account group financial statements. (See chapter 3, paragraph 3.12.) If supporting schedules accompany combining and individual fund and account group financial statements, the auditor's report should state whether the information in those schedules is presented fairly in conformity with GAAP in all material respects in relation to the GPFS taken as a whole, or disclaim an opinion on such information. (See appendix A, example A.3, "Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements, Presented Together With Supporting Schedules Reported on as Supplementary Data.")

**18.44 *Financial Statements of a Primary Government That Omit the Financial Data of Each Component Unit.*** GASB Cod. sec. 2100 establishes criteria for defining the financial reporting entity of a governmental unit. That section describes the legally separate organizations, functions, and activities of government (that is, component units) that should be included in the GPFS of a governmental financial reporting entity. GASB Cod. sec. 2600 recognizes that there may be circumstances in which a primary government may issue separate financial statements that exclude all component units (either blended or discretely presented) considered a part of the financial reporting entity, and requires that the limitations of the financial statements be clearly disclosed. Such separate financial statements for the primary government, in the absence of specific identification by the auditor, could be misinterpreted to be the complete financial statements of the financial reporting entity. Accordingly, when reporting on these separate primary government financial statements, the auditor should—

- Indicate that the financial statements are those of the primary government and not of the financial reporting entity.
- Define the term *primary government*.
- Give an appropriate opinion on the primary government financial statements.
- Opine that the primary government financial statements do not fairly present financial position and results of operations of the financial reporting entity in conformity with GAAP.

See appendix A, example A.4, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit."

**18.45** A financial reporting entity may include some, but not all, component units in the financial reporting entity financial statements. In that situation, the financial statements should be described as GPFS of the financial reporting entity and the auditor should consider the need to express a qualified or adverse opinion because of a departure from GAAP (see also paragraph 3.12 herein). A qualified or adverse auditor's report should include an explanatory paragraph that describes the omitted component unit(s) and discloses the effects of the omission on the financial statements, if reasonably determinable. (See appendix A, example A.5, "Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity.")

**18.46 *General-Purpose Financial Statements That Omit a Fund Type, Account Group, or Fund.*** If financial statements for fund types or account groups that should be included in the GPFS (such as the general fixed-assets account group or all proprietary funds) are omitted, the auditor is required to express a qualified opinion on the financial statements because of a departure from GAAP. If the financial statements for an individual fund that should be included in the GPFS (such as an individual proprietary fund) are omitted, the auditor should consider the need to express a qualified or an adverse opinion on the financial statements (see also paragraph 3.12 herein). A qualified or adverse auditor's report should include an explanatory paragraph that describes the omitted fund type, account group, or fund and discloses the effects on the financial statements, if reasonably determinable. (See appendix A, example A.6, "Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group," and example A.7, "Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund-Type.")

**18.47 *Individual Fund Financial Statements.*** The auditor may be engaged to audit financial statements of only a specified fund or group of funds that are not intended to present fairly financial position, results of operations, or cash flows of either the financial reporting entity component unit in conformity with GAAP. In such a case, the auditor's report should include a middle paragraph calling attention to the fact that the financial statements are not intended to present financial position and the results of operations of the financial reporting entity or component unit. (See appendix A, example A.8, "Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity," and example A.9, "Unqualified Opinion on an Enterprise Fund's Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity.")

**18.48 *General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity.*** Using the criteria established by GASB Cod. sec. 2100, many governmental units' financial reports may include component units that were heretofore reported separately. In certain cases, the financial statements of those units may be unaudited and may result in the auditor's report on the GPFS being qualified or disclaimed, depending on the materiality of the unaudited component unit to the governmental unit's financial statements. (See appendix A, example A.11, "Qualified Opinion on General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity.")

**18.49 *Financial Statements of a Department Constituting Less Than a Fund.*** The auditor may issue an unqualified opinion on the financial statements of a department (or agency) that constitutes less than a fund. The auditor's report should include a middle paragraph that indicates that the statements present information for only a portion of the financial reporting entity. (See appendix A, example A.15, "Unqualified Opinion on Financial Statements of a Department Constituting Less Than a Fund.")

**18.50 *Part of the Audit Performed by Another Auditor.*** When the auditor is serving as principal auditor and another auditor has audited a material portion of the financial statements, the principal auditor should consider the guidance in chapter 3 and whether to refer to the work of the other auditor. (See appendix A, example A.12(A), "Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function or Activity by Other Auditors;" A.12(B), "Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements When One Fund or Component Unit Representing Less Than All of a Fund Type Has Been Audited by Other Auditors;" and A.13, "Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of *All* of a Fund Type by Other Auditors.")

**18.51 *Summary Financial Information.*** The auditor may be engaged to report on summary information issued by a state or local governmental unit in a document that refers to, but does not include, the GPFS. (See appendix A, example A.27, "Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23" and A.28, "Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23.")

## Special Reports

**18.52** If an independent auditor is engaged to audit financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP, as defined in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), the independent auditor should follow the guidance in SAS No. 62. (See appendix A, example A.14, "Unqualified Opinion on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles.")

**18.53** If the auditor is engaged to audit financial statements presented in conformity with neither GAAP nor an other comprehensive basis of accounting, the auditor should use the standard form of report, modified for the departures from GAAP.

## Jointly Signed Reports

**18.54** During recent years, a number of governments have required that CPA firms proposing to perform audits of their financial statements provide for minority or smaller firms, or both, to participate in the conduct of the audit. In some cases, those requirements have been met by principal auditors simply by subcontracting a portion of the audit to the minority or smaller firms. In those circumstances, the report on the audit is signed by only the principal auditor in the manner contemplated by SAS No. 1, section 543.

**18.55** In other circumstances, the independent auditors participating in the audit have each signed the report in their individual capacities. The profession's standards do not provide for sharing the responsibility for an audit of the financial statements of a single entity by two or more independent auditors. Each individual or firm signing an audit report should be considered to be separately expressing an opinion on the financial statements. Signing the report in an individual capacity is appropriate only if the individual or firm has complied with GAAS and is in a position that justifies being the only signatory of the report. In chapter 21, "Single Audit Planning," paragraphs 21.15 through 21.20 discuss joint audits and reliance on other auditors in a single audit.

**18.56** A joint endeavor by two firms to conduct an audit could take the form of a legal entity, just as individuals band together to form a firm. In that situation, the report might be signed with the joint venture name. However, before undertaking such an approach, the auditors should consider the implications of ethics rules on the use of fictitious names and state licensing statutes.

## Chapter 19

# Association With Financial Statements Included in Official Statements

### Introduction

**19.01** Debt securities generally are issued on a negotiated sale, a competitive bid basis, or in a private placement. Negotiated offerings are made by the issuer to one or more underwriters who resell the bonds to the public. Competitive bid sales are based on sealed bids submitted by underwriters, investors to the underwriter, or the underwriting group that submitted the best acceptable bid. A private placement occurs for small issues, many times with a local bank. An official statement is generally prepared by the issuer of debt securities with the assistance of financial advisors, bond counsel, and, frequently, the entity's independent accountants.

**19.02** The GFOA published *Disclosure Guidelines for Offerings of Securities by State and Local Governments* in 1978 and a revised version, *Disclosure Guidelines for State and Local Government Securities (Guidelines)*, in 1991. The 1991 booklet provides current guidelines for the preparation of official statements and suggests the format and content of information contained in them. *Guidelines* strongly suggests that the GPFS with an independent auditor's report be included in the official statement. The major areas of change and emphasis are as follows.

- Recommend standardization of the order of presentation for items presented in the official statement.
- Simplify and condense the information presented on cover pages.
- Recommend a format for introductions to official statements.
- Recognize separate issuers of governmental, conduit, and credit-enhanced issues.
- Give guidance on disclosures for both nonprofit and for-profit conduit securities.
- Add new sections for disclosure regarding conduits, credit enhancements, and basic documentation.
- Recommend that governmental issuers receive assurances as to disclosures by credit enhancers and conduit borrowers.
- Restate procedural statements to conform with the Securities and Exchange Commission (SEC) Rule 15c2-12 requirements for dealers.
- Provide new procedural statements regarding assurances from credit enhancers, conduit issuers, and notices of sale and bid forms.
- Include appendices containing supplementary and background materials, and a complete index.

**19.03** Governmental units are exempt from the reporting and registration requirements under the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act). However, the federal antifraud provisions of those acts that relate to the adequacy of disclosures apply to governmental unit security offerings. The best known of those provisions is section 10b-5 of the 1934 Act, which imposes civil liability for unlawful acts; for example, misrep-

representations or omissions of material facts by any person in the offering or sale of securities, including securities issued by governmental units.

**19.04** The SEC promulgated Rule 15c2-12 regarding the disclosure responsibilities of underwriters of municipal securities. This rule and the accompanying SEC releases have major implications for the procedures to be followed by issuers in providing information to the market to assist underwriters in meeting their responsibilities. Accordingly, the *Guidelines* reflects the requirements of the rule, especially in the section entitled "Procedural Statements."

**19.05** In addition to the SEC Rule and its impact, the general area of disclosure has been the subject of study by various groups. These efforts led to the formulation of additional guidance for use by market participants. Especially noteworthy contributions are those of the National Federation of Municipal Analysts, the National Council of State Housing Agencies, the Municipal Securities Rulemaking Board, and the Public Securities Association.

**19.06** An auditor is not required to participate in, or undertake, any procedures with respect to an official statement. In the following situations, however, the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), for guidance on responsibilities concerning information in the official statement other than the financial statements covered by his or her opinion.

- Manually signing the independent auditor's report included in the offering document.
- Providing written consent to the use of the independent auditor's report in the official statement. (See paragraphs 19.12 and 19.13.)
- Reviewing a draft of the official statement at the client's request.
- Assisting in the preparation of the financial information included in an official statement.
- Issuing an agreed-upon procedures or comfort letter on information included in an official statement.

The guidance in SAS No. 8 provides that the auditor has no obligation to perform any procedures to corroborate other information contained in an official statement. However, the auditor should read the information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. (See paragraph 4 of SAS No. 8 [AICPA, *Professional Standards*, vol. 1, AU sec. 550.04].) Paragraph 5 of SAS No. 8 (AICPA, *Professional Standards*, vol. 1, AU sec. 550.05) further suggests the action an auditor should take if, based on that reading, there is a material misstatement of fact in the other information.

**19.07** The following three dates are generally critical in a debt offering of a governmental entity, though the time period between them may vary.

- a. The preliminary official statement (POS) is issued to all prospective buyers of the debt securities.
- b. The official statement (OS) is issued at the time of sale (sometimes referred to as the effective date) and identifies the buyer of the debt and the related actual debt service requirements of the new debt.
- c. The closing date represents the date the transaction is finalized and the cash is transferred from the buyer to the governmental entity.

## Letters for Underwriters

**19.08** When the accountant is asked to issue a letter consenting to the use of the auditor's report in the official statement, the effective date of the consent can be the POS date or the OS date. When the accountant is asked to prepare a letter for the underwriter, the letter can be as of the POS date or the OS date with updating letters issued as of the OS date (if applicable) and the closing date. The procedures in these letters can be cut off as much as five business days before the date of the letter.

**19.09** Underwriting agreements between the governmental issuer and the underwriters may require the auditor to prepare a comfort letter addressed to the underwriters. SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), defines the term underwriters and gives guidance to accountants in providing letters to *underwriters* in the 1933 Act and to certain other requesting parties. Accountants may provide a comfort letter to a broker-dealer or other financial intermediary acting as principal or agent in offerings of securities issued or backed by governmental entities exempt from registration under the 1933 Act only if the broker-dealer or other intermediary provides the required representation letter. The required elements of the representation letter from a broker-dealer or other financial intermediary are as follows:

- The letter should be addressed to the accountants.
- The letter should contain the following:

This review process, applied to the information relating to the issuer, is (will be) substantially consistent with the due diligence review process that we would perform if this placement of securities (or issuance of securities in an acquisition transaction) were being registered pursuant to the Securities Act of 1933 (the Act). We are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act.
- The letter should be signed by the requesting party.

When a party requesting a comfort letter has provided the accountants with the required representation letter, the accountants should refer in the comfort letter to the requesting party's representations. (See example P in the appendix to SAS No. 72 [AICPA, *Professional Standards*, vol. 1, AU sec. 634.63]. Example P is a typical comfort letter in a non-1933 Act offering, including the required underwriter representations.) If the required representation letter is not provided by the broker-dealer or other intermediary, accountants, who are requested to issue letters in conjunction with securities offerings should follow the guidance in SAS No. 76, *Amendments to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634). When a comfort letter is requested by a party other than the underwriter, broker-dealer, or other financial intermediary, accountants should not provide that party with a comfort letter or the letter described in paragraph 9 of SAS No. 76. Instead, accountants may provide the party with a report on agreed-upon procedures and should refer to SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), or Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), as applicable, for guidance.

**19.10** SAS No. 72 requires accountants to perform a review, as discussed in SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), to provide negative assurance in a comfort letter on interim financial information. If the accountant has not performed such a review, he or she is limited to stating procedures performed and findings obtained.

## **Status as Experts and Use of Financial Statements**

**19.11** Two interpretations relating to SAS No. 37, *Filings Under Federal Securities Statutes* (AICPA, *Professional Standards*, vol. 1, AU sec. 711), were issued and are found in AICPA, *Professional Standards*, vol. 1, AU sec. 9711.12-.15 and 9711.16-.17. The interpretations addressed the auditor's consent (a) to being named as an expert and (b) to the use of an audit report in an offering document other than one registered under the 1933 Act.

### **Consenting to Be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933**

**19.12** This Interpretation (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.12-.15) states that when a client wishes to make reference to the auditor's role in an offering document in connection with a securities offering that is not registered under the 1933 Act, the caption "Independent Auditors" should be used to title that section of the document; the caption "Experts" should not be used, nor should the auditors be referred to as experts anywhere in the document. The following paragraph should be used to describe the auditor's role.

#### Independent Auditors

The financial statements as of December 31, 19XX, and for the year then ended, included in this offering circular, have been audited by ABC, independent auditors, as stated in their report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditors as experts, the auditor should not permit inclusion of the auditor's report in the offering document.

### **Consenting to the Use of an Audit Report in an Offering Document Other Than One Registered Under the Securities Act of 1933**

**19.13** The auditor is not required but may provide a consent in an offering document other than one registered under the 1933 Act. The Interpretation (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.16-.17) provides example language that the auditor may use:

We agree to the inclusion in this offering circular of our report, dated February 5, 19XX, on our audit of the financial statements of [name of entity].



## **Part VII**

# **Audits of Federal Financial Assistance**

## Chapter 20

### *Introduction to the Single Audit*

#### **The Single Audit Act of 1984**

**20.01** The Single Audit Act of 1984 (the Single Audit Act) established requirements for audits of financial statements of state and local governments, and for testing and reporting on internal controls and compliance with laws and regulations relevant to federal financial assistance programs. A brief history of the single audit concept, which may be useful in obtaining an understanding of these requirements, is presented in appendix G, “Key Events in the History of Auditing Federal Programs.” The Act required the director of the OMB to issue policies, procedures, and guidelines for implementing the Act.

**20.02** The Single Audit Act was to achieve the following goals:

- a. Improve state and local government’s financial management of federal financial assistance programs.
- b. Establish uniform requirements for audits of federal financial assistance provided to state and local governments.
- c. Promote efficient and effective use of audit resources.
- d. Ensure that federal departments and agencies, to the maximum extent practicable, rely on and use audit work done pursuant to the Single Audit Act.

**20.03** The Single Audit Act and OMB Circular A-128 require state and local governments that receive total federal financial assistance equal to or in excess of \$100,000 in a fiscal year to have an audit performed in accordance with the Single Audit Act. A state or local government receiving at least \$25,000, but less than \$100,000, of total federal financial assistance in its fiscal year has the option of having an audit performed in accordance with the Act and OMB Circular A-128, or a program audit in accordance with the federal laws and regulations governing the programs in which the government participates. Governments receiving less than \$25,000 in federal assistance in a fiscal year are not required to have either an audit under the Single Audit Act and OMB Circular A-128, or a program audit, although they are required to maintain records to support federal assistance programs and may be subject to state or local government audit requirements.

#### **Single Audit Literature**

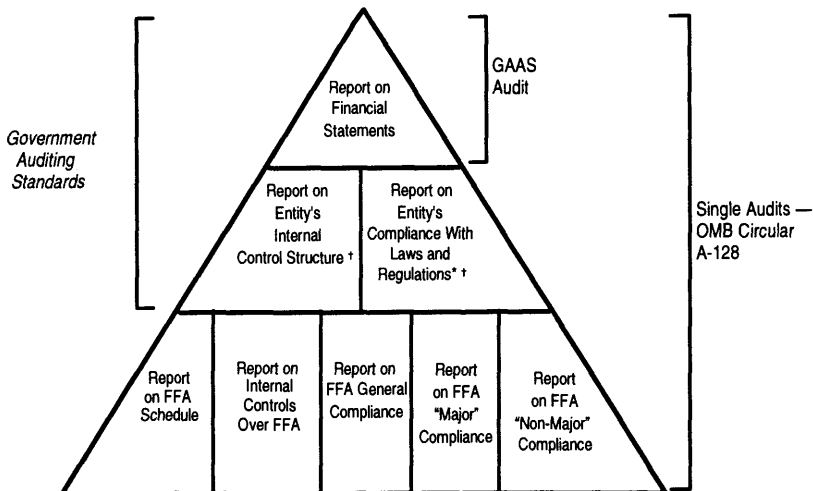
**20.04** The OMB has provided guidance for implementing the Single Audit Act in OMB Circular A-128, in the September 1990 revision of the *Compliance Supplement for Single Audits of State and Local Governments* (A-128 Compliance Supplement), and in the November 1987 *Questions and Answers on the Single Audit Process of OMB Circular A-128* (OMB’s Circular A-128 Q&A Guidance), included herein as appendix D. Additional guidance has been provided by the Standards Committee of the President’s Council on Integrity and Efficiency (PCIE), which represents the Federal Inspectors General, and by the AICPA. PCIE Statement No. 2 refers to the “50 percent rule” on the consideration of the internal control structure used in administering federal

financial assistance programs. PCIE Statement No. 3 addresses the use of a cyclical approach to obtaining an understanding of internal control structure policies and procedures applicable to nonmajor programs. Single audit guidance issued by the OMB, the PCIE, the AICPA, and others is summarized in appendix H, "Single Audit Literature."

## **Components of a Single Audit**

**20.05** A single audit has two main components: an audit of the financial statements and an audit of federal financial assistance. Each component results in a variety of audit reports. An overview of the various reports issued in a single audit is presented in exhibit 20.1, "Levels of Reporting in Governmental Single Audits."

## Exhibit 20.1

Levels of Reporting in Governmental Single Audits<sup>\*</sup>GAAS Audit v. *Government Auditing Standards* Audit v. Single Audit

<sup>\*</sup> See paragraphs 5.33 and 5.34 for a discussion of the report on illegal acts, which may also be required.

<sup>†</sup> *Government Auditing Standards*, paragraphs 5.15 and 5.16, permits auditors to report on the internal control structure and compliance with laws and regulations in the report on the financial statements or in separate reports. See paragraphs 4.14, 5.29, 24.03, and 24.04 herein for further discussion.

## Applicability of GAAP

**20.06** The Single Audit Act and OMB Circular A-128 require the auditor to express an opinion on whether the financial statements of the governmental unit as a whole are fairly presented in conformity with GAAP. For various reasons (such as legal or regulatory requirements), some state and local governmental units prepare their financial statements on a basis of accounting other than GAAP (for example, cash basis). If financial statements are prepared on a comprehensive basis of accounting other than GAAP, the auditor's report should be prepared in accordance with SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), which requires the report to (a) state or refer to a note to the financial statements that states the basis of presentation and (b) state that the basis of accounting is a comprehensive basis of accounting other than GAAP.

## Financial Statement Audit

**20.07** The financial statement audit is performed in accordance with GAAS and the financial audit standards contained in *Government Auditing Standards*, which incorporates the AICPA field work and reporting standards. See appendix A, "Illustrative Auditor's Reports," paragraph A.2, for a discussion of report wording referring to these standards.

**20.08** A financial statement audit in accordance with *Government Auditing Standards* results in auditor reporting on the financial statements, the internal control structure, and compliance with laws and regulations. The results of procedures performed in the financial statement audit form the basis for reporting on compliance with applicable laws and regulations and the internal control structure (see also paragraphs 5.26 and 5.27 herein).

## Audit of Federal Financial Assistance

**20.09** In an audit of federal financial assistance, OMB Circular A-128 requires the auditor to issue a report on the Supplementary Schedule of Federal Financial Assistance (Supplementary Schedule). Chapter 22, "Supplementary Schedule of Federal Financial Assistance," addresses this subject. The auditor also issues reports on compliance with laws and regulations applicable to federal financial assistance, and on internal control structure policies and procedures relevant to compliance with laws and regulations applicable to federal financial assistance. These reports are issued in addition to the reports required by *Government Auditing Standards*. The various levels of reporting in a single audit of state and local governments are shown in exhibit 20.1.

## Key Concepts in Auditing Federal Financial Assistance

**20.10** Two factors, the relative size of federal financial assistance programs and the compliance requirements applicable to those programs, determine the scope of the auditor's work and the reports to be issued in an audit of federal financial assistance.

### Size—Major v. Nonmajor Programs

**20.11** The Single Audit Act established the following criteria for determining if a federal financial assistance program is a *major* program:

<i>When Total Cash and Noncash Expenditures of Federal Financial Assistance (FFA) for All Programs Are</i>		<i>Major Federal Assistance Program Means Any Program With Federal Expenditures That Exceed</i>
<i>More Than</i>	<i>Equal to or Less Than</i>	
\$ 300,000	\$ 10 million	\$ 300,000
\$ 10 million	\$100 million	3% of FFA
\$100 million	\$ 1 billion	\$ 3 million
\$ 1 billion	\$ 2 billion	\$ 4 million
\$ 2 billion	\$ 3 billion	\$ 7 million
\$ 3 billion	\$ 4 billion	\$10 million
\$ 4 billion	\$ 5 billion	\$13 million
\$ 5 billion	\$ 6 billion	\$16 million
\$ 6 billion	\$ 7 billion	\$19 million
\$ 7 billion		\$20 million

**20.12** In applying the foregoing criteria, recipients of federal financial assistance are required to consider all forms of federal assistance, including those that may not involve cash expenditures, such as commodities, loans, or loan guarantees. Question 33 in OMB's Circular A-128 Q&A Guidance addresses how guarantee, loan, or insurance programs are treated in the Supplementary Schedule and how to determine whether they are major programs. Any federal financial assistance program with expenditures (or any other forms of assistance) not meeting the criteria for a major program is a *nonmajor* program. The auditor's responsibilities for testing internal control structure and compliance with laws and regulations for major programs generally exceed those for nonmajor programs. Guidance on determining whether a program is a major program or a nonmajor program is provided in paragraphs 22.06 through 22.08, which discuss pass-through award considerations, and paragraphs 22.09 through 22.12, which provide guidance on noncash award programs.

## Compliance Requirements

**20.13** The term *compliance requirements* is commonly used to refer to the laws, regulations, and other requirements that should be considered in an audit of federal financial assistance. The OMB's A-128 Compliance Supplement provides suggested audit procedures for performing two types of compliance testing—testing for compliance with the specific requirements of individual programs and with the general requirements applicable to all federal assistance programs. These are summarized below. Chapter 23, "Performing the Audit of Federal Financial Assistance Programs," addresses the auditor's responsibility for these requirements.

## Specific Requirements

**20.14** Specific requirements that, if not complied with, could have a material effect on a federal financial assistance program generally pertain to the following matters:

- Types of services allowed or unallowed
- Eligibility
- Matching, level of effort, and earmarking requirements

- d.* Special reporting requirement
- e.* Special tests and provisions

In addition, the following matters are tested in a single audit:

- a.* Claims for advances and reimbursements
- b.* Amounts claimed or used for matching

See chapter 23 herein for a more detailed discussion of these matters.

## **General Requirements**

**20.15** The A-128 Compliance Supplement also identifies the following as general compliance requirements applicable to federal financial assistance programs:

- a.* Political activity
- b.* Davis-Bacon Act
- c.* Civil rights
- d.* Cash management
- e.* Relocation assistance and real property acquisition
- f.* Federal financial reports
- g.* Allowable costs/cost principles
- h.* Drug-Free Workplace Act
- i.* Administrative requirements

## **Auditors' Responsibilities in Audits of Federal Financial Assistance—An Overview**

**20.16** As previously noted, the auditor's responsibility for testing and reporting on internal control structure and compliance in audits of federal financial assistance is determined by the size of each federal financial assistance program and the compliance requirements applicable to it.

### **Internal Control Structure Over Federal Financial Assistance**

**20.17** In a single audit, the auditor considers the internal control structure policies and procedures relevant to assuring compliance with both specific and general requirements. The extent of the auditor's work in this area is in addition to the consideration of the internal control structure as part of the financial statement audit. Guidance on the auditor's consideration of the internal control structure used in administering federal financial assistance programs in a single audit is discussed in chapter 23.

### **Compliance With Laws and Regulations**

**20.18** The interaction between program size and type of compliance requirement results in three distinct levels of responsibility for testing and reporting on compliance with laws and regulations in a single audit. Detailed guidance on carrying out these responsibilities is presented in chapter 23, and a detailed discussion of the Schedule of Findings and Questioned Costs is presented in chapter 24, "Reporting Under the Single Audit Act and OMB Circular A-128."

## Chapter 21

# Single Audit Planning

## Auditing and Reporting Considerations

**21.01** The auditor should determine the nature, timing, and extent of work to be performed and prepare written audit programs. The Single Audit Act and OMB Circular A-128, and *Government Auditing Standards*, establish audit requirements to satisfy the needs of federal program managers and other users of the schedule of federal financial assistance and related auditor's reports. In planning a single audit, the auditor considers several matters in addition to those ordinarily considered in an audit of financial statements in accordance with GAAS. This chapter discusses overall planning considerations in a single audit. Matters relevant to planning the financial statement audit component of the single audit are discussed in detail in chapter 3, "Planning the Audit."

## Overall Single Audit Planning Considerations

**21.02** Matters that are relevant to planning both components of a single audit—the financial statement audit and the audit of federal financial assistance programs—include the following:

- Relationships with and responsibilities of the cognizant agency
- *Government Auditing Standards*
- Reporting entity definition
- Determination of the audit period
- Initial-year audit considerations
- Joint audits and reliance on other auditors
- State grant compliance requirements
- Engagement letters
- Subrecipients and related grantor monitoring
- Materiality

## Relationships With and Responsibilities of the Cognizant Agency

**21.03** OMB Circular A-128 defines the cognizant agency audit organization (cognizant agency) as the federal agency assigned by the OMB to carry out the responsibilities concerning single audits of governments as defined in paragraph 11 of the Circular. The independent auditor may, when professional judgment indicates it is appropriate, communicate with the cognizant agency before, during, and after the audit to avoid or minimize disagreements or other problems.

**21.04** If a single audit planning meeting is held with the recipient and the cognizant agency, the auditor may wish to discuss the following subjects:

- a. The scope of the audit, that is, the single audit reporting entity (see paragraphs 21.10 and 21.11 for a discussion of the definition of the reporting entity)
- b. The audit plan
- c. The scope of testing of programs for specific compliance requirements



- d.* The intended use of the OMB's A-128 Compliance Supplement
- e.* Any sampling plan
- f.* The form and content of the Supplementary Schedule
- g.* The scope of the consideration of the internal control structure (including the government's significant internal control policies and procedures, including those controls designed to provide reasonable assurance that federal programs are being managed in compliance with laws and regulations)
- h.* The auditor's reporting on compliance and internal control structure
- i.* Identification of federal financial assistance programs, including those that are considered major
- j.* Testing of compliance requirements
- k.* Testing the monitoring of subrecipients
- l.* Status of prior-year findings and questioned costs

If the cognizant agency disagrees with the significant elements of the audit plan or any other significant items, these matters should be resolved between the recipient, the cognizant agency, and the auditor before field work commences. Communications with and decisions rendered by the cognizant agency should be documented.

**21.05** The OMB has designated cognizant agencies for state agencies and large local governmental units. Smaller governments not assigned a cognizant agency are under the general oversight of the federal agency that provides them with the most funds (the oversight agency), whether directly or indirectly.

**21.06** OMB Circular A-128 states that a cognizant agency shall have the following responsibilities:

- a.* Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of Circular A-128.
- b.* Provide technical advice and act as liaison to state and local governments and independent auditors.
- c.* Obtain or make quality control reviews of selected audits made by nonfederal audit organizations, and provide the results, when appropriate, to other interested organizations.
- d.* Promptly inform other affected federal agencies and appropriate federal and local law enforcement officials of any reported illegal acts or irregularities.
- e.* Advise the recipient of audits that have been found not to have met the requirements set forth in the Circular. In such instances, the recipient will be expected to work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient and federal awarding agencies of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance of an independent auditor may result in referral of the auditor to appropriate professional bodies for disciplinary action.
- f.* Coordinate, to the extent practicable, audits made by or for federal agencies that are in addition to the audits made pursuant to the Circular, so that the additional audits build upon such audits.

- g. Oversee the resolution of the audit findings that affect the programs of more than one agency. Additional information on cognizant agency responsibility is contained in the *Federal Cognizant Agency Audit Organization Guidelines* (the Orange Book). It provides guidance for promoting quality audits, processing audit reports, defining major inadequacies, and providing notification of irregularities. Auditors may wish to consider its contents before conducting a single audit.

**21.07** Although each federal agency has agreed to exercise its cognizant responsibilities in accordance with policies set forth in the Orange Book, those guidelines are limited to broad policy statements and leave the design and execution of specific procedures to the individual cognizant agencies. The auditor should not presume that all conditions agreed to by a cognizant agency for one engagement will be the same for other engagements. In some states, cognizant agency responsibilities are delegated to state agencies by the federal cognizant agency.

## General Oversight Agencies

**21.08** The OMB has stated that the responsibilities of an oversight agency are not as broad as those of a cognizant agency. An oversight agency's primary responsibility is to provide advice and counsel to recipients and their auditors, on request. If deemed necessary, an oversight agency may take on additional responsibilities, such as ensuring that audits are conducted and transmitted to appropriate federal officials. In some cases, a federal department or agency may assume the oversight responsibility for a single class of governments within a state even though that department or agency does not provide the most funds to every government in that class. An example might be that the Department of Health and Human Services assumes oversight responsibilities for all counties in a state because of their continuing involvement in social service programs.

## Government Auditing Standards

**21.09** The Single Audit Act and OMB Circular A-128 require the audit to be performed by an independent auditor in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. *Government Auditing Standards* states, in chapter 4, "Field Work Standards for Financial Audits," paragraphs 4.34 and 4.35, that "working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments" (see paragraphs 3.34 and 3.35 for further discussion). The auditor's working papers may be subject to a review by federal inspectors general. Appendix I, "Federal Quality Control Procedures," describes federal quality control procedures. *Government Auditing Standards* is discussed in Part I, "Introduction," of this guide.

## Reporting Entity Definition

**21.10** One of the initial tasks during the planning process of a single audit is determining whether management has properly defined the reporting entity. The Single Audit Act does not specify what constitutes a government's entire operations, except that it does allow governments the option of excluding public hospitals, colleges, and universities.

**21.11** The Single Audit Act permits the recipient government to limit its single audit to cover only those departments or agencies that received, expended, or otherwise administered federal financial assistance. To date, few

governments have found the limitation on departments and agencies handling federal financial assistance to be beneficial. The Act also permits a series of audits of individual departments or agencies; in general, this option has been elected only by state and larger local governments. PCIE Position Statement No. 1 provides guidance for such cases. Paragraph 21.20 provides guidance for situations in which the principal auditor of the primary government is not the auditor for some of the component units included in the financial statements of the primary government.

## Determination of the Audit Period

**21.12** Audits of federal financial assistance programs are required to be performed annually unless the state or local government had—by January 1, 1987—a constitutional or statutory requirement for less frequent audits. For such governments, the cognizant agency was empowered to permit biennial audits, covering both years, if the government so requested.

**21.13** A single audit should cover the reporting entity's financial transactions for its fiscal year, not the grant year or period of the program being funded. Thus, the audit might include only a portion of the transactions of certain assistance programs, because a portion of the program's transactions might not fall within the period covered by the audit.

## Initial-Year Audit Considerations

**21.14** An auditor accepting, or contemplating accepting, an engagement in which the federal financial assistance programs of the preceding period were audited by another auditor should be guided by SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). If the federal financial assistance programs have not been previously audited, the auditor should discuss with the recipient and the cognizant agency the need to perform any additional audit work for the prior unaudited periods. If additional work is not required, testing for the prior unaudited period would be limited to balances as of the end of that unaudited period.

## Joint Audits and Reliance on Other Auditors

**21.15** As required by the Single Audit Act, OMB Circular A-128, (section 7505(c)) prescribes policies, procedures, and guidelines:

as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the Single Audit Act requirements

**21.16** Accordingly, many governments have required that their audits be performed on a joint venture or subcontract basis with small, minority-owned, or female-owned independent accounting firms. In such cases, it may be necessary to refer to the work of other auditors in certain of the principal auditor's reports.

**21.17** Before agreeing to perform a joint audit or to subcontract with another firm, the auditor should consider the guidance in SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543), and Ethics Interpretation 101-10 of the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12), concerning the effect on independence of relationships with entities included in the governmental financial statements.

**21.18** At a minimum, the auditor in a joint audit or a multiple-auditor environment should—

- a. Ensure his or her own independence of the oversight entity and of each component unit in the reporting entity.
- b. Confirm the other auditor's independence under Ethics Interpretation 101-10.
- c. Obtain separate audited financial statements and supplementary schedules of federal financial assistance of each component unit.
- d. Obtain representation that the other audit organization and its personnel have met the requirements of *Government Auditing Standards*, including continuing professional education (CPE), internal quality control, and external triennial quality control review.

**21.19** In some circumstances, each independent audit firm participating in the audit will sign the appropriate reports. This is appropriate only when each auditor or firm has complied with GAAS and *Government Auditing Standards* and is in a position that would justify being the only signatory of the report.

**21.20** Another common occurrence is the separation of a single audit between the principal auditor of the oversight entity and a secondary auditor of a component unit included in the financial statements of the oversight entity. The principal auditor's report on the financial statements of the oversight entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component unit. The principal auditor may also need to refer to the programs audited by other auditors in his or her reports on the Schedule of Federal Financial Assistance, compliance, and internal control structure, as they relate to federal financial assistance administered by the component unit. In such cases, the auditor should follow the guidance in SAS No. 1, section 543.

## State Grant Compliance Requirements

**21.21** An auditor may be engaged to test and report on compliance with state and local laws and regulations in addition to testing and reporting on the compliance requirements imposed by the Single Audit Act and OMB Circular A-128. Many states also make grants to their political subdivisions and prescribe audit requirements. Guidance for engagements related to management's written assertion about an entity's compliance with specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500). In conjunction with the financial statement audit, the auditor should obtain an understanding of applicable state reporting and compliance requirements that have a direct and material effect on the financial statements being audited. (See chapter 5, "Testing and Reporting on Compliance with Laws and Regulations.")

**21.22** When the engagement includes auditing one or more grants subject to state compliance requirements, the auditor should consider performing the following steps:

- a. Read the grant agreement and any amendments.
- b. Obtain any applicable audit guidance from the state grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- c. When appropriate, discuss the scope of testing that is expected to be performed with the state grantor agency.

**21.23** Nonfederal assistance received by an entity should be distinguished from the federal pass-through funds received. Federal pass-through funds, discussed in chapter 22, "Supplementary Schedule of Federal Financial Assistance," paragraph 22.06, unlike nonfederal pass-through funds, are considered part of the total federal financial assistance received by an entity and are subject to audit in accordance with the Single Audit Act and OMB Circular A-128. The primary recipient of federal financial assistance providing pass-through funds to a subrecipient has the responsibility to notify the subrecipient of (a) the amount of federal financial assistance included in the pass-through and (b) the federal program name, the federal grantor agency from which the resources were obtained, and the *Catalog of Federal Domestic Assistance* (CFDA) number from which such assistance was derived. When the subgrantor cannot identify the amount of federal and nonfederal pass-through funds, a conservative approach is for the subrecipient to treat such funds as all federal. (See Question 38 of the OMB's "Questions and Answers on the Single Audit Process of OMB's Circular A-128" (OMB's Circular A-128 Q&A Guidance) included herein as appendix D.)

### Engagement Letters

**21.24** It is in the best interest of both the auditor and the entity to document the scope of the audit in an engagement letter or audit contract. This will minimize confusion and help ensure a proper understanding of the responsibilities of each party.

**21.25** In addition to the elements of an engagement discussed in chapter 3, auditors should consider including items such as the following:

- A statement that the audit will be made pursuant to *Government Auditing Standards*
- A list of the additional reports required by the Single Audit Act and OMB Circular A-128
- Mention of the auditor's and the entity's responsibilities with respect to reporting illegal acts noted during the audit (paragraphs 5.18 through 5.25 of *Government Auditing Standards*)

### Subrecipients and Related Grantor Monitoring

**21.26** When a recipient is also a subrecipient, the recipient's single audit responsibilities are not changed except that the Supplementary Schedule should separately identify subgrants. If a recipient is also a subgrantor for one or more of its grants, the subgrantor has specific responsibilities for monitoring subrecipients. For a discussion of the effect of pass-through awards, see paragraph 22.06 in chapter 22. Questions 21 through 30 of OMB's Circular A-128 Q&A Guidance, in appendix D, herein, discuss subrecipient audits. The single audit testing should cover subrecipient monitoring. See chapter 23, "Performing the Audit of Federal Financial Assistance Programs," paragraphs 23.25 through 23.34 for additional discussion of subrecipient considerations.

### Materiality

**21.27** In an audit of compliance with the specific requirements governing major federal financial assistance programs in accordance with the Single Audit Act and OMB Circular A-128, the auditor's consideration of materiality differs from that in an audit of financial statements in accordance with GAAS. In an audit of an entity's financial statements, materiality is considered in relation to the financial statements being audited (that is, at the fund type or

individual fund financial statement level). However, in auditing an entity's compliance with specific requirements governing major federal financial assistance programs in accordance with the Single Audit Act and OMB Circular A-128, the materiality of the transaction or finding is considered in relation to the major program to which the transaction or finding relates.

**21.28** With respect to general compliance requirements, such as compliance with the provisions of the Davis-Bacon Act, materiality is generally considered at the program level. With respect to those general requirements, such as maintenance of a drug-free workplace, where compliance is not quantifiable, materiality is generally considered at the GPFS level. See chapter 23, paragraphs 23.79 through 23.81 for a further discussion.

**21.29** Because OMB Circular A-128 requires the auditor to determine whether an entity has complied with specific requirements of *each* major program and not on all the major programs combined, reaching a conclusion about whether instances of noncompliance are material to a major program requires consideration of the type and nature of the noncompliance, as well as the actual and projected impact of the noncompliance on each major program in which the noncompliance was noted. An amount that is material to one major program may not be material to a major program of a different size. Furthermore, the level of materiality relative to a particular major program can change from one period to another. Notwithstanding materiality, *all* instances of noncompliance discovered and any related questioned costs are required to be included in the auditor's report on compliance or described in the schedule of findings and questioned costs.

### Other Planning Considerations

**21.30** Other important planning considerations include—

- Identification of federal financial assistance programs (see chapter 22).
- Internal control structure used in administering federal financial assistance (see chapter 23).
- Subrecipient considerations (see chapter 23).
- Specific compliance requirements (see chapter 23).
- General compliance requirements (see chapter 23).
- Findings and questioned costs (see chapter 24).
- Reporting (see chapter 24).
- Program or compliance audits during the fiscal year under an audit performed by a federal grantor agency, the GAO, or a state subgrantor agency.

## Chapter 22

# Supplementary Schedule of Federal Financial Assistance

**22.01** The Single Audit Act and OMB Circular A-128 require the auditor to report on the Supplementary Schedule. The Supplementary Schedule, prepared by management, reports the total expenditures for each federal financial assistance program as identified in the CFDA. Federal financial assistance programs that have not been assigned a CFDA number should be identified separately under the caption *Other Federal Assistance*. The recipient should be careful to aggregate multiple awards with the same CFDA number, including direct and pass-through awards, to determine major programs.

**22.02** The Supplementary Schedule should list by federal grantor agency, all federal financial assistance programs administered by the recipient, both major and nonmajor, regardless of whether they are cash or noncash programs. This facilitates identification by a grantor agency of its federal financial assistance programs. The Supplementary Schedule should be presented in a format to separately report cash and noncash programs.

## Types of Federal Financial Assistance and Payment Methods

**22.03** There are over one thousand individual grant programs and a number of distinct types of federal financial assistance payment methods. These programs are described in the CFDA.

**22.04** Programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through eight nonfinancial and seven financial types of assistance, which may be received by governments in various ways. Some programs provide for assistance to be received directly or under reimbursement arrangements in which the recipient government bills the grantor for costs as incurred, other programs provide for advance payments, and still others permit the recipient government to draw against letters of credit as grant expenditures are incurred. The seven principal types of financial assistance that are available to state and local governments are the following.

- a. *Formula grants*—Allocations of money are made to states or their subdivisions in accordance with a distribution formula prescribed by law or administrative regulation for activities of a continuing nature not confined to a specific project.
- b. *Project grants*—The funding, for fixed or known periods, of specific projects or the delivery of specific services or products that is made without liability for damages for failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, survey grants, construction grants, and unsolicited contractual agreements.
- c. *Direct payments*—Financial assistance of this kind consists of the following:
  - *Direct payments for specified use*—Financial assistance from the federal government is provided directly to individuals, private

firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon a particular performance by the recipient.

- *Direct payments with unrestricted use*—Financial assistance from the federal government is provided directly to beneficiaries who satisfy federal eligibility requirements and imposes no restrictions on the recipient as to how the money is spent. Included are payments under retirement, pension, and compensation programs.

Direct payments do not include solicited contracts for the procurement of goods and services for the federal government. Generally, this type of assistance is not received by a governmental entity.

- d. *Direct loans*—Financial assistance is provided through the lending of federal moneys for a specific period, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- e. *Guaranteed/insured loans*—Programs include an arrangement made by the federal government to indemnify a lender against part or all of any defaults by those responsible for repayment of loans.
- f. *Insurance*—Financial assistance is provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through private carrier and may or may not involve the payment of premiums.
- g. *Sale, exchange, or donation of property and goods*— Programs provide for the sale, exchange, or donation of federal real property or personal property (including land, buildings, and equipment), commodities (including food and drugs), and other goods. This does not include the loan of, use of, or access to federal facilities or property.

**22.05** Certain grants have matching requirements under which the participating state or local government must contribute a proportionate share of the total costs of a program or administrative cost allowance received.

## Pass-Through Awards

**22.06** The Single Audit Act and OMB Circular A-128 require that state or local government redistributions of federal financial assistance to other governments or not-for-profit organizations, known as pass-through awards, be treated by the last recipient as though they were received directly from the federal government. The recipient of a pass-through award is a subrecipient. Accordingly, pass-through awards should be included in the scope of the single audit on the same basis as federal financial assistance programs that are received directly. The Supplementary Schedule should separately report assistance received directly and assistance received through pass-through awards. The Supplementary Schedule should not include nonfederal funds in pass-through awards. (See paragraph 21.23.)

**22.07** The individual sources of governmental financial assistance may not be readily identifiable because the assistance from various levels of government may have been commingled. When commingled assistance is identified, the audit requirements prescribed by each individual source should be considered. For example, a department of a state government may receive federal



financial assistance and pass the federal funding, supplemented with state funds, through to a local unit of government. When this occurs, the local governmental unit may be responsible for complying with state as well as federal requirements governing that assistance.

**22.08** If it is believed that financial assistance could represent assistance combined from various levels of government (including federal), management should review contracts, grants, or other documentation to determine the source of the financial assistance. If the documentation indicates that the financial assistance received from various sources has been commingled, the recipient should ask the grantor agency (a) whether the assistance provided includes assistance from a federal grantor or other source and (b) to provide the name of the source, amount of that additional financial assistance, and the name of the program and CFDA number through which that assistance was provided. If the commingled portion cannot be separated to specifically identify federal financial assistance, the total financial assistance should be included in the Supplementary Schedule with a footnote describing the commingled nature of the funds. A conservative approach to determining the nature and extent of the tests that are appropriate for commingled funds is to consider the total amount to be federal financial assistance.

## Noncash Awards

**22.09** Most federal financial assistance is in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions with state or local governments. These programs may include food stamps, food commodities, loan guarantees, loans, interest-rate subsidies, or insurance. The value of noncash assistance should be reported as part of the Supplementary Schedule. That is, the value of a federal loan guarantee, loan, insurance program, food stamps issued, or commodities distributed is presented in the Supplementary Schedule.

**22.10** Interest subsidies or administrative cost allowances permitted during the fiscal year under a loan or loan guarantee program should be reported in the Supplementary Schedule.

**22.11** The following table shows the bases generally used to determine the amounts to be reported as noncash assistance.

<i>Types of Noncash Assistance</i>	<i>Basis Used to Determine Amounts to Be Reported as Program Expenditures</i>
Loans except guaranteed student loan programs and loan guarantees	New loans made during the year plus the balance of loans made in previous years for which the federal government is at risk plus interest subsidy, cash, or administrative cost allowance received
Insurance	Value of insurance contract
Food stamps	Value of food stamps distributed during the year
Commodities	Value of commodities distributed during the year

**Note:** Value as used in this table is to be determined by methods or prices prescribed by the federal departments making the award.

**22.12** Management uses the preparation of the Supplementary Schedule required by OMB Circular A-128, as a means by which to identify major and nonmajor federal financial assistance programs. When determining major programs, the inclusion of noncash programs should not result in other programs being excluded from the definition of major programs. Question 33 of "Questions and Answers on the Single Audit Process of OMB Circular A-128," (OMB's Circular A-128 Q&A Guidance), presented herein as appendix D, provides guidance for including noncash loan and loan guarantee programs in the determination of major programs as follows:

If, based on the above, it is determined that a loan or loan guarantee program is a major program, this should not affect the identification of major programs, using the criteria applicable to the Supplementary Schedule. Sometimes including a large loan program in the base used to determine major programs may distort the base. Therefore, if the number of programs determined to be major is significantly affected by the inclusion of a guaranteed loan program in total federal assistance, the auditor should use judgment as to whether the guarantee program should be included when determining which other programs are major.

This point is illustrated below. If major awards are based on 3 percent of \$97,600,000 (total federal financial assistance expenditures), a major program would be defined as having expenditures equal to or greater than \$2,928,000 (programs B, F, and G). However, when programs F and G are excluded, a major program is defined as the larger of 3 percent of \$7,100,000 or \$300,000 (in this case, \$300,000 [3 percent of \$7,100,000 is \$213,000]). Therefore, programs A, D, and E, in addition to programs B, F, and G, are major programs.

<i>Program / Federal Grantor</i>	<i>Federal Financial Assistance Expenditures (\$000)</i>
Cash Program A—Labor	\$ 1,335
Cash Program B—DHHS	3,000
Cash Program C-1—Education	175
Cash Program C-2—Education	280
Cash Program D—HUD (a subgrant from County)	310
Subtotal—cash expenditures	<u>5,100</u>
Commodities Program E—USDA (subgrant from State)	2,000
Subtotal expenditures—cash and commodities	7,100
Loan Program F—HUD	33,500 *
Loan Guarantee Program G—USDA	57,000 *
Total FFA expenditures	<u>\$97,600</u>

DHHS = Department of Health and Human Services; HUD = Department of Housing and Urban Development; USDA = United States Department of Agriculture; FFA = Federal Financial Assistance.

\* Total of new loans made during the year plus prior-year loans for which the federal government is at risk.

## Supplementary Schedule of Federal Financial Assistance

**22.13** Management's responsibility for identifying federal financial assistance programs is established in the following requirement of OMB Circular A-128:

In order to determine which major programs are to be tested for compliance, [s]tate and local governments shall identify in their accounts all [f]ederal funds received and expended and the programs under which they were received. This shall include funds received directly from [f]ederal agencies and through other [s]tate and local governments.

Management, after identifying all sources of federal financial assistance, is required to prepare the Supplementary Schedule. The requisite information includes—

- Identification of each program (normally by program or grant title, including the federal agency and federal CFDA number) and indication that the federal financial assistance is either direct or pass-through.
- Presentation of those federal programs that have not been assigned CFDA numbers as other federal financial assistance. Total expenditures for each federal financial assistance program, classified by grantor, department, or agency.
- Total federal financial assistance expenditures.
- Identification of major programs.

These required disclosures appear in exhibit 22.1, "Illustrative Supplementary Schedule of Federal Financial Assistance for the Year Ended June 30, 19X1—Minimum Data Required by OMB Circular A-128 Only."

**22.14** Depending on the circumstances of the engagement and the requirements of the entity, the Supplementary Schedule may also present information such as the following:

- Matching contributions
- Amount of the program award and time period of the award
- Receipts or revenue recognized
- Beginning and ending balances, such as unexpended amounts or accrued (deferred) amounts
- Subtotals by federal grantor agency
- Footnotes (for example, basis of accounting, reporting entity, basis for valuing noncash programs)

Such additional optional disclosures are illustrated in exhibit 22.2, "Illustrative Supplementary Schedule of Federal Financial Assistance for the Year Ended June 30, 19X1—Including Additional Optional Disclosures."

**22.15** In assessing the appropriateness of management's identification of major and nonmajor federal financial assistance programs in the Supplementary Schedule, the auditor should consider, among other matters, evidence obtained from audit procedures performed in the audit of financial statements, such as procedures performed to evaluate the completeness and classification of recorded revenues and expenditures. This may include confirmations from granting federal agencies or recipient governments in an audit of a subrecipient.

**22.16** The financial information included in the Supplementary Schedule is based on the entity's fiscal year and should be derived from the government's

books and records from which the GPFS were prepared. It should also be prepared as far as practicable on a basis consistent with other federal grant reports. However, the Supplementary Schedule's data may not fully agree with or be traceable to other grant reports or to the entity's financial statements because, among other things, (a) the grant reports may be prepared on a different fiscal period than the entity's fiscal year, or (b) the grant reports may include cumulative (from prior years) data as well as current-year data. In such cases, the Supplementary Schedule should be reconcilable to the government's books and records. Although a reconciliation among the Supplementary Schedule, the grant reports, and the entity's financial statements should be possible, it is not required to be presented in the Supplementary Schedule.

**22.17** Because federal grantor agencies are the primary users of the Supplementary Schedule, financial data for state and other nonfederal assistance are not usually presented. If such nonfederal data are presented, the auditor should discuss the form of presentation with the recipient to ensure that nonfederal data are clearly identified.

**22.18** In the event that the government is unable to obtain a CFDA number, which is frequently the case for new federal programs and research and development programs, the Supplementary Schedule should clearly state that the CFDA number is not available. If such a program is a major program for which specific testing is mandatory, the auditor should read the grant agreement and related regulations and, if necessary, contact the grantor agency for audit guidance.

## Exhibit 22.1

**Illustrative Supplementary Schedule of Federal Financial Assistance  
for the Year Ended June 30, 19X1—  
Minimum Data Required by OMB Circular A-128 Only**

<i>Federal Grantor/Pass-Through Grantor Program Title*</i>	<i>Federal CFDA Number</i>	<i>Pass- Through Grantor's Number</i>	<i>Expenditures†</i>
U.S. Dept of Education Direct Programs:			
Impact aid	84.041‡	NA	\$XXX
Bilingual education	84.003	NA	XXX
			XXX
Pass-through State Department of Education			
Chapter 1	84.011	XXXXXX	\$XXX
Chapter 2	84.151	XXXXXX	XXX
Vocational education—basic grants to states	84.048	XXXXXX	XXX
			XXX
			XXX
Total Department of Education			
U.S. Department of Housing and Urban Development Direct Programs:			
Community development block grant— entitlement	14.218	NA	XXX
Urban development action grant	14.221	NA	XXX
			XXX
Pass-through State Department of Community Development:			
Community development block—states program	14.219	XXXXXX	XXX
Total U.S. Department of Housing and Urban Development			XXX
Other Federal Assistance§			
Department of Defense Engineering study contract	—	—	XXX
<b>TOTAL FEDERAL ASSISTANCE EXPENDED</b>			<b>\$XXX</b>

CFDA = Catalog of Federal Domestic Assistance

NA = Not available

\* All major and nonmajor programs should be individually identified, including those completed or terminated during the audit period.

† If the schedule is prepared on a basis of accounting other than GAAP, the basis should be disclosed. A reconciliation to the general-purpose financial statements may be provided.

‡ Major program as defined by OMB Circular A-128.

§ Significant programs or grants that have not been assigned a CFDA number should be identified separately.

## Exhibit 22.2

**Illustrative Supplementary Schedule of Federal Financial Assistance  
For the Year Ended June 30, 19X1—  
Including Additional Optional Disclosures**

<i>Federal Grantor/ Pass- Through Grantor Program Title *</i>	<i>Federal CFDA Number</i>	<i>Pass- Through Grantor's Number</i>	<i>Program or Award Amount</i>	<i>Cash/ Accrued or (Deferred) Revenue at July 1, 19X1</i>	<i>Receipts or Revenue Recognized</i>	<i>Disburse- ments/ Expenditures</i>	<i>Cash/ Accrued or (Deferred) Revenue at June 30 19X1†</i>
U.S. Department of Education Direct Programs:							
Impact aid	84.041	NA	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Bilingual education	84.003	NA	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Passed-through State Department of Education:							
Chapter 1	84.011	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Chapter 2	84.151	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Vocational education— basic grants to states	84.048	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Total Department of Education				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
U.S. Department of Housing and Urban Development Direct Programs:							
Community development block grant— entitlement	14.218	NA	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Urban development action grant	14.221	NA	X,XXX,XXX	(X,XXX)	0	0	(X,XXX)‡
				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Pass-through State Department of Community Development:							
Community development block grant— states program	14.219	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Total U.S. Department of Housing and Urban Development				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX

(Continued)

<i>Federal Grantor / Pass- Through Grantor Program Title *</i>	<i>Federal CFDA Number</i>	<i>Pass- Through Grantor's Number</i>	<i>Program or Award Amount</i>	<i>Cash / Accrued or (Deferred) Revenue at July 1, 19X1</i>	<i>Receipts or Revenue Recognized</i>	<i>Disburse- ments / Expenditures</i>	<i>Cash / Accrued or (Deferred) Revenue at June 30 19X1†</i>
Other Federal Assistance§							
Department of Defense Engineering study contract	—	—	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
TOTAL FEDERAL ASSISTANCE				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX

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CFDA = Catalog of Federal Domestic Assistance.

NA = Not available.

\* All major and nonmajor programs should be individually identified, including those completed or terminated during the audit period.

† If the schedule is prepared on a basis of accounting other than GAAP, the basis should be disclosed. A reconciliation to the general-purpose financial statements may be provided.

‡ This item is intended to show that programs can be open without monies being received or expended during the audit period. Such programs should be included in the schedule.

§ Significant programs or grants that have not been assigned a CFDA number should be identified separately.

This schedule may be expanded to show local government identifying numbers, matching contributions, and other information. The schedule may also show information by individual grant, with columns added for grant number and grant period.

## Chapter 23

# ***Performing the Audit of Federal Financial Assistance Programs***

## **Auditing Federal Financial Assistance Programs**

**23.01** Federal financial assistance, as discussed in chapter 22, “Supplementary Schedule of Federal Financial Assistance,” comes in many forms. Federal financial assistance programs come with a set of general and specific program requirements as shown in the OMB *Compliance Supplement for Single Audits of State and Local Governments* (A-128 Compliance Supplement). Although there is no requirement that the auditor test all federal financial assistance programs and related compliance, the Single Audit Act does contain audit requirements for many of the larger federal financial assistance programs.

**23.02** The audit of federal financial assistance programs results in reports on the internal control structure used in administering federal financial assistance and on compliance with laws and regulations applicable to the federal financial assistance. This chapter discusses the work the auditor performs to provide a basis for issuing those reports. Chapter 24, “Reporting Under the Single Audit Act and OMB Circular A-128,” discusses the reports themselves.

## **Internal Control Structure Used in Administering Federal Financial Assistance**

### **Single Audit Act Requirements**

**23.03** The Single Audit Act and OMB Circular A-128 define the internal control structure for federal financial assistance program purposes as the plan of organization and methods and procedures adopted by management to ensure that—

- a.* Resource use is consistent with laws, regulations, and policies.
- b.* Resources are safeguarded against waste, loss, and misuse.
- c.* Reliable data are obtained, maintained, and fairly disclosed in reports.

**23.04** The Single Audit Act and OMB Circular A-128 require the auditor to “determine and report” whether the organization has internal control structure policies and procedures in place to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. As part of these tests, the auditor should—

- a.* Perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance.
- b.* Examine the organization’s control system for monitoring its subrecipients and obtaining and acting on subrecipients’ audit reports.



**23.05** A literal interpretation of the Single Audit Act would require the auditor to perform tests of controls relevant to each federal financial assistance program regardless of the dollar amount of the program expenditures. However, the following approach for considering the internal control structure was developed in consultation with representatives of the OMB, the GAO, and the Inspectors General.

## Major Programs

**23.06** For major federal financial assistance programs (as defined in the Single Audit Act and OMB Circular A-128), the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that he or she considers relevant to preventing or detecting material noncompliance with—

- a. Specific requirements applicable to those programs, addressing types of services allowed or not allowed; eligibility; matching, level of effort, or earmarking; reporting; and special tests and provisions.
- b. General requirements addressing civil rights, political activity, cash management, the Davis-Bacon Act, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, the Drug-Free Workplace Act, and certain administrative requirements.
- c. Requirements governing claims for advances and reimbursements and amounts claimed or used for matching.

**23.07** The following paragraphs discuss the components of audit risk in a compliance audit of major programs. Audit risk—the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance—is composed of inherent risk, control risk, and detection risk. For purposes of a compliance audit of major federal financial assistance programs, these components are defined as follows:

- a. *Inherent risk*—The risk that material noncompliance with requirements applicable to a major federal financial assistance program could occur, assuming there are no related internal control structure policies or procedures.
- b. *Control risk*—The risk that material noncompliance that could occur in a major federal financial assistance program will not be prevented or detected on a timely basis by the entity's internal control structure policies and procedures.
- c. *Detection risk*—The risk that an auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major federal financial assistance program does not exist when in fact such noncompliance does exist.

**23.08** When considered together, the Single Audit Act and OMB Circular A-128 require the auditor to perform procedures that assess inherent and control risk and that restrict detection risk. The following paragraphs discuss the provisions of the Single Audit Act and OMB Circular A-128 that pertain to each of these components of risk, provide guidance on applying those provisions, and explain how the components of risk interrelate in providing a basis for the auditor's opinion on compliance.

**23.09 Inherent risk.** Paragraph 8 of OMB Circular A-128 includes the following guidance, related to inherent risk, on determining the nature and extent of testing compliance with requirements that, if not complied with, could have a material effect on a major federal financial assistance program.

The selection and testing of transactions shall be based on the auditor's professional judgment considering such factors as the amount of expenditures for the program and the individual awards; the newness of the program or changes in its conditions; prior experience with the program, particularly as revealed in audits and other evaluations (e.g., inspections, program reviews); the extent to which the program is carried out through subrecipients; the extent to which the program contracts for goods or services; . . . the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

**23.10** In assessing inherent risk, the auditor may also consider the results of any procedures performed as part of the audit of the financial statements, and of any tests of compliance with the general requirements.

**23.11 Control risk.** The Single Audit Act requires the auditor to determine and report whether the entity has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. Paragraph 8(a) of OMB Circular A-128 expands on this requirement.

The auditor must make a study and evaluation of internal control systems used in administering [f]ederal assistance programs. The study and evaluation must be made whether or not the auditor intends to place reliance on such systems. As part of this review, the auditor shall:

- a. Test whether these internal control systems are functioning in accordance with prescribed procedures.
- b. Examine the recipient's system for monitoring subrecipients and obtaining and acting on subrecipient audit reports.

**23.12** These provisions of the Single Audit Act and OMB Circular A-128 encompass internal control structure policies and procedures relevant to an audit of an entity's compliance with the specific requirements applicable to major federal financial assistance programs. Paragraphs 23.13 through 23.15 discuss, in general terms, the auditor's consideration of these policies and procedures in an audit of compliance with requirements applicable to major federal financial assistance programs. Paragraphs 23.25 through 23.34 specifically address subrecipient considerations.

**23.13** In satisfying the internal control provisions of the Single Audit Act and OMB Circular A-128, the auditor should obtain an understanding of the design of relevant internal control structure policies and procedures and whether they have been placed in operation. This understanding should be sufficient to plan the audit of compliance, enabling the auditor to—

- a. Identify the types of potential material noncompliance.
- b. Consider matters that affect the risk of material noncompliance.
- c. Design effective tests of compliance with requirements applicable to major federal financial assistance programs.

**23.14** OMB Circular A-128's requirement to "test whether these internal control systems are functioning in accordance with prescribed procedures" involves performing tests of controls to evaluate the effectiveness of the design

and operation of the policies and procedures in preventing or detecting material noncompliance. Procedures performed to obtain an understanding of the internal control structure may be considered tests of controls if they provide evidential matter about the effectiveness of the design and operation.

**23.15** After obtaining an understanding of the internal control structure policies and procedures, the auditor should assess control risk. Assessing control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major federal financial assistance program. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for the opinion on compliance.

**23.16 Detection risk.** OMB Circular A-128 states that a compliance audit of major federal financial assistance programs should "include the selection and testing of a representative number of charges from each major [f]ederal assistance program." Such compliance testing serves to restrict detection risk. In determining an acceptable level of detection risk, the auditor considers the level to which he or she seeks to restrict audit risk related to the major federal financial assistance program and the assessed levels of inherent risk and control risk. As the assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of compliance tests performed.

**23.17** In determining the nature of his or her tests of compliance with requirements governing major federal financial assistance programs, the auditor should consider the nature of those requirements. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, audit procedures should be designed to provide the auditor with sufficient evidential matter to evaluate how management used the federal financial assistance. In designing compliance tests, auditors may wish to consider the procedures suggested in the A-128 Compliance Supplement for testing compliance with the requirements specific to many of the larger federal financial assistance programs.

**23.18** The tests of controls performed should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319.34 and .35). The auditor should perform such procedures regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level. Tests of controls may be omitted only in areas where the internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance, in which case a reportable condition or a material weakness should be reported. For purposes of SAS No. 55 (AICPA, *Professional Standards*, vol. 1, AU sec. 319), a reportable condition is a matter coming to the auditor's attention that, in his or her judgment, should be communicated to the audit committee (or its equivalent) because it represents a significant deficiency in the design or operation of the internal control structure that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements or to administer federal financial assistance programs in accordance with applicable laws and regulations. A reportable condition may be of such magnitude as to be considered a material weakness. A material weakness in the internal control structure is a reportable condition in which

the design or operation of one or more of the internal control structure elements do not reduce, to a relatively low level, the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited, or that noncompliance with laws and regulations that would be material to a federal financial assistance program, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

## Nonmajor Programs

**23.19** The auditor may find that the total amount of major federal financial assistance program expenditures is less than 50 percent of the recipient organization's total federal cash and noncash federal financial assistance expenditures. In such circumstances, the auditor should perform tests of controls over all major and nonmajor programs until at least 50 percent of federal financial assistance program expenditures are subject to tests of controls performed in accordance with paragraphs 23.06 through 23.18. However, as stated in PCIE Statement No. 6, *Questions and Answers on OMB Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions*, question 60, a preferred alternative to selecting the next largest nonmajor programs (to reach the 50 percent of federal expenditures) is to select nonmajor programs on a rotating basis so that all but clearly insignificant programs are covered at least once every three years.

**23.20** For all other nonmajor federal financial assistance programs, the auditor should, at a minimum, obtain an understanding of each of the three elements of the organization's internal control structure—the control environment, the accounting system, and control procedures—that he or she considers relevant to preventing or detecting material noncompliance with the requirements listed in paragraph 23.06. The understanding should include knowledge about the design of relevant policies, procedures, and records and about whether the organization has placed them in operation. In obtaining this understanding, the auditor is not required to perform tests of controls, as suggested by paragraph 17 of SAS No. 55 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.17).

**23.21** If the recipient organization has no major federal financial assistance programs, the scope of the auditor's consideration of the internal control structure used in administering federal financial assistance programs should be comparable to the scope applicable to major federal financial assistance programs, as described in paragraphs 23.06 through 23.18, for the largest programs that in the aggregate are equal to or greater than 50 percent of total federal financial assistance program expenditures. The auditor's consideration of the internal control structure relating to the remainder of the federal financial assistance programs need not exceed that described in paragraph 23.20.

## Multiple Operating Units

**23.22** Federal financial assistance programs are often administered by several organizational components within a recipient entity. Each component may maintain separate internal control structure policies and procedures relevant to the programs it administers. In those situations, the auditor should consider the policies and procedures of each separate component in accordance with the criteria previously discussed.

**23.23** However, Statement Nos. 2 and 3 of the PCIE Standards Subcommittee indicate that, in certain circumstances, the auditor may obtain the required understanding of internal control structure policies and procedures applicable to nonmajor programs on a cyclical basis over a number of years if the recipient organization has a large number of nonmajor programs administered by multiple operating components of the organization. At a minimum, for a cyclical approach to be acceptable, each nonmajor program on which the cyclical approach is used should be covered at least once every three years. In the first year of the review cycle, the auditor should obtain an understanding of, and assess the control risk for, internal control structure policies and procedures for any program that has not previously been included in the auditor's consideration of the internal control structure. Also, the auditor should obtain an understanding of, and assess the control risk for, policies and procedures for new nonmajor programs the first year federal financial assistance is received. The decision to use the cyclical approach should be discussed with the cognizant agency. If a cyclical approach is used, the auditor's report on the internal control structure should be modified to describe clearly the coverage provided for nonmajor programs. This cyclical approach has very limited application and is not intended to be used on the vast majority of single audit engagements. It is intended to be used in the single audits of states and other very large governmental entities.

## Documentation

**23.24** The auditor should document his or her understanding of internal control structure policies and procedures used in administering federal financial assistance programs. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. The auditor should also document the results of tests of controls applied to those policies and procedures. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraph 23.18, then the rationale for omitting such tests should be documented.

## Subrecipient Considerations

**23.25** Many governmental units that are primary recipients make sub-contract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The following are some examples of a typical recipient-subrecipient relationship:

- A state department of education receives federal assistance, which it disburses on a formula or other basis, to local school districts within the state.
- A regional planning commission receives federal funds for food programs for elderly and low-income individuals. These funds are disbursed to not-for-profit organizations to support their food programs.
- A state department of social services receives federal funds, which are disbursed to a county government.

**23.26** Subrecipient relationships should not be confused with vendor relationships. A subrecipient is defined as any person or government department, agency, or establishment that receives federal financial assistance to carry out a program through a state or local government, but does not include an individual that is a beneficiary of such a program. Compliance requirements exist for monitoring the performance of subrecipients but not vendors. A sub-

recipient may also be a direct recipient of federal financial assistance (OMB Circular A-128, paragraph 5m). A subrecipient is distinguished from a vendor by the degree of responsibility assumed to help the recipient meet the requirements of the assistance award. A vendor is responsible for meeting the requirements of a procurement contract for goods or services issued by its recipient customer. When a recipient enters into a procurement contract to buy goods or services, the other party to the contract is not a subrecipient for purposes of the single audit. In the absence of a procurement contract or similar agreement, the party should initially be considered a subrecipient. A subrecipient relationship does not exist when a contract for units of services exists and the vendor did not participate in meeting the requirements of the assistance award. Typical of this buyer-vendor relationship is the purchase of medical services (Medicare-funded services), vocational training services (except certain Job Training Partnership Act contracts), or a participating government's purchase of supplies or equipment through a regional pooled purchasing program that was funded in part by federal assistance. Although subrecipients generally have cost reimbursement-type arrangements, it is possible to have a fee-per-occasion-of-service-type arrangement. In situations where the recipient and the auditor cannot determine whether a subrecipient or vendor relationship exists, guidance should be sought from the cognizant agency. In OMB's Circular A-128 Q&A Guidance, presented herein as appendix D, questions 22 and 25 clarify this issue.

**23.27** Redistribution of federal financial assistance to subrecipients is normally done only on the basis of properly completed and approved grant applications. These written agreements include (a) requirements that subrecipients comply with conditions set by the initial federal agency and (b) any additional requirements established by the pass-through agency.

**23.28** Under the requirements of the Single Audit Act and OMB Circular A-128, when, in a single fiscal year, a recipient of federal financial assistance passes \$25,000 or more of such assistance in a single subgrant through to one or more subrecipients, the primary recipient is responsible for determining whether the subrecipient expends that assistance in accordance with applicable laws and regulations. Furthermore, OMB Circular A-128 provides that, in such instances, the primary recipient should—

- a. Determine whether state or local subrecipients have met the applicable federal audit requirements.
- b. Determine whether the subrecipient has controls in place to ensure that federal financial assistance is being expended in accordance with applicable laws and regulations.
- c. Ensure that appropriate corrective action is taken within six months after receipt of a subrecipient's auditor's report that identifies reported instances of noncompliance with federal laws and regulations.
- d. Consider whether subrecipient audits necessitate adjustment of the recipient's own records.
- e. Require each subrecipient to permit independent auditors to have access to their records and financial statements as necessary to comply with federal audit requirements.

The primary recipient's responsibilities may be discharged by (a) relying on independent audits of the subrecipients, performed in accordance with OMB Circular A-128 or A-133 (or, in some cases, Circular A-110), (b) relying on appropriate procedures performed by the primary recipient's internal audit or

program management personnel, (c) expanding the scope of the independent financial and compliance audit of the primary recipient to encompass testing of subrecipients' charges, or (d) a combination of these procedures. Question 25 in OMB's Circular A-128 Q&A Guidance provides useful guidance on subrecipient monitoring responsibilities. (See appendix D.)

**23.29** The primary recipient is also responsible for (a) reviewing audit and other reports submitted by subrecipients and identifying questioned costs and other findings pertaining to the federal financial assistance passed through to the subrecipients and (b) properly accounting for and pursuing the resolution of questioned costs and ensuring that prompt and appropriate corrective action is taken in instances of material noncompliance with laws and regulations.

**23.30** In establishing its control policies and procedures to monitor subrecipients, management should design procedures that are sufficient to determine a subrecipient's noncompliance with applicable federal laws and regulations. The financial operations of subrecipients related to the federal assistance may be subjected to timely and periodic audits, including Circular A-110, A-128, or A-133 single audits. If they are not, management should develop alternative procedures for monitoring their subrecipients.

**23.31** Management may perform procedures such as the following to monitor subrecipients:

- Review submitted Circular A-128 or A-133 single audit (or Circular A-110 audit) reports and evaluate them for completeness and for compliance with applicable laws and regulations.
- Evaluate audit findings, issue appropriate management directions to the subrecipient, and determine whether a plan of corrective action has been prepared and implemented.
- Review grant applications submitted by potential subrecipients to determine the following.
  - Applications were approved by subgrantor management before any funds are awarded.
  - Applications were filed in a timely manner.
  - Each application contains the condition that the subrecipient comply with the federal requirements set by the original federal grantor agency.
- Determine whether funds are disbursed to subrecipients only on an as-needed basis.
- Determine whether disbursements to subrecipients are approved and are based on properly completed reports submitted in a timely manner.
- Ascertain that refunds due from subrecipients are billed and collected in a timely manner.
- Ensure that the subgrant agreement identifies the federal program and the Catalog of Federal Domestic Assistance (CFDA) number, and that the subgrantor (or its auditor) has access to the subrecipient's appropriate records.
- Determine whether procedures exist to ensure that subrecipients and those using the funds meet all eligibility requirements.
- Determine whether reports received from subrecipients are reviewed on a timely basis and whether all unusual items are fully investigated.
- Review evidence of previously detected deficiencies and determine whether corrective action was taken.

**23.32** As part of the consideration of the internal control structure over federal financial assistance, the auditor of the primary recipient should obtain an understanding of the design of control policies and procedures for monitoring subrecipients and determine whether they have been placed in service. The auditor should also assess the level of control risk by evaluating the effectiveness of the primary recipient's monitoring system in determining the subrecipients' noncompliance with the applicable rules and regulations. When awards to subrecipients are part of a major program (or a nonmajor program used to meet the 50 percent rule), the auditor tests the controls the government uses to monitor subrecipients. The tests of controls may include inquiry, observation, and inspection of documentation, or a reperformance by the auditor of some or all of the procedures identified in paragraph 23.31 as management responsibilities. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the control structure policies and procedures, and professional judgment.

**23.33** The instances of noncompliance reported in a subrecipient's audit report that are related to the primary recipient's programs are not required to be included in the primary recipient's audit report. However, the primary recipient's auditor should consider the effects of reported instances of noncompliance, events, or indications of weaknesses in the primary recipient's monitoring system that could have a material effect on *each* of the recipient's major federal financial assistance programs.

**23.34** If subrecipient audits have not been made and the grant awards are material to programs administered by the primary recipient, the scope of the primary recipient's audit can be expanded by management to include testing of the subrecipient records for compliance with the applicable provisions of the general and specific requirements. If the scope of the audit is not expanded, the auditor should consider disclosing the amount of the subgrant as a questioned cost and modifying the auditor's reports on compliance with laws and regulations. In addition, the auditor should consider whether a reportable condition or material weakness in the internal control structure may exist.

## Compliance Testing

### Reporting Requirements

**23.35** The auditor has differing levels of reporting responsibility for compliance with laws and regulations that pertain to federal financial assistance programs. For major programs, the auditor is required to express an opinion on whether the audited entity complied, in all material respects, with the specific requirements applicable to each major program. Auditors provide limited assurance on the entity's compliance with general requirements and on the specific requirements applicable to any transactions selected from nonmajor programs. This limited assurance is positive concerning compliance for those items tested and negative for those items not tested. Instances of noncompliance, regardless of materiality, are reported in a schedule of findings and questioned costs or in the auditor's report on compliance.

### Sources of Compliance Requirements

**23.36** The A-128 Compliance Supplement was issued by the OMB to assist auditors in performing single audits and supplements OMB Circular A-128. It



describes general compliance requirements that are national policies, identified by federal grantor agencies, prescribed by statute, executive order, or other authoritative sources and that apply to the federal financial assistance programs of two or more federal agencies. It also describes compliance requirements specific to many of the larger federal financial assistance programs and suggests procedures for testing compliance with the specific requirements. These compliance matters should be tested during the audit of federal financial assistance programs.

**23.37** Besides describing the specific requirements, the A-128 Compliance Supplement includes references to the *Code of Federal Regulations* and other sources of information about the requirements. The auditor should consider referring to these other sources of information in planning to test compliance with specific requirements. The auditor should also be aware that compliance requirements may change over time.

**23.38** Major federal government programs not included in the A-128 Compliance Supplement may prescribe specific requirements governing financial assistance. To obtain an understanding of the specific requirements of the major programs not included in the A-128 Compliance Supplement, the auditor should consider reviewing the CFDA. Generally updated on an annual basis, the CFDA contains all federal financial assistance programs, with citations to applicable laws and regulations associated with those programs, as well as the names of program staff who serve as reference individuals for each program.

**23.39** Since the A-128 Compliance Supplement does not contain the compliance requirements for all federal financial assistance programs, management may also identify major compliance features by (a) referring to the Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions, issued by the OMB in October 1991 (which may contain compliance requirements for programs that are not covered in the A-128 Compliance Supplement), (b) consulting the Regional Inspector General for Audit for the federal grantor agency to determine if a compilation of compliance features is available, or (c) referring to the *Code of Federal Regulations* cited in the grant agreement. A number of federal agencies responsible for programs not covered in the A-128 Compliance Supplement have developed guidance to assist in the audit of those programs. This additional guidance is usually in the same format as the A-128 Compliance Supplement and may be obtained from the government's cognizant agency.

## Specific Compliance Requirements

**23.40** The auditor should obtain an understanding of the specific requirements applicable to each of the recipient's major federal financial assistance programs to determine the nature, timing, and extent of procedures to be performed as a basis for expressing an opinion on compliance with those requirements. Specific requirements, if not complied with, may have a material effect on a federal financial assistance program and generally pertain to the following matters:

- a. *Types of services allowed or unallowed*—The goods or services entities may purchase with financial assistance
- b. *Eligibility*—The characteristics of individuals or groups to whom entities may give financial assistance

- c. *Matching, level of effort, and/or earmarking*—The amounts entities should contribute from their own resources toward projects for which federal financial assistance is provided
- d. *Reporting*—The reports entities must file in addition to those required by the general requirements
- e. *Special tests and provisions*—Other provisions for which federal agencies have determined noncompliance could materially affect the program (for example, programs that require recipients to hold public hearings on the proposed use of federal financial assistance or that set deadlines for the expenditure of federal financial assistance)

In addition, OMB Circular A-128 requires independent auditors to determine whether—

- a. Federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared.
- b. Amounts claimed or used for matching were determined in accordance with OMB Circular A-87, *Cost Principles for State and Local Governments*, and the OMB's *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*, presented herein as appendix F, The Common Rule—*Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*, Issued by the Office of Management and Budget, March 1988.

These matters should be addressed in the auditor's report on major program compliance. Those requirements are considered both general and specific by OMB. Thus, the same audit procedures can be used to test compliance with those requirements.

**23.41** Although each requirement in the A-128 Compliance Supplement is accompanied by suggested audit procedures that can be used to test compliance with laws and regulations, those are not the only audit procedures an auditor may use. The auditor should use professional judgment in determining the nature, timing, and extent of substantive tests of compliance with specific requirements. Question 10 in the OMB's Circular A-128 Q&A Guidance states that "for the programs contained in the Compliance Supplement the audit of the requirements contained in the Supplement will meet the requirements of Circular A-128."

## Major Program Compliance

**23.42** To support the auditor's opinion on compliance with the specific requirements applicable to *each* major program, auditors are required to perform procedures to test each requirement. These procedures may specify that the auditor select a representative number of charges from each major program and test them for compliance with the specific requirements of that program. In determining the extent of testing, auditors should assess audit risk and materiality in relation to the individual major program being tested. Materiality should not be measured in relation to major programs taken as a whole or in relation to the GPFS. Usually, the assessed level of materiality for an individual major program is less than either of these two factors. The level at which materiality is assessed is critical to determining the scope of the auditor's work and evaluating the results of audit procedures.

**23.43** When reporting on compliance with specific requirements, auditors consider the impact of instances of noncompliance at two levels of materiality. First, instances of noncompliance with program requirements need to be judged in light of the materiality level established for the applicable program; that is, the materiality of known and projected instances of noncompliance must be assessed relative to the affected program to determine if an audit report modification is necessary. Second, if the affected program is material to the financial statements being audited, the impact of the known and projected instances of noncompliance should be considered when reporting on those financial statements as a whole; that is, the impact of the instances of noncompliance must be considered relative to the materiality level set for the combined or individual fund financial statements being reported on. (It should be noted that several instances of noncompliance that may not be individually material at either level need to be assessed to determine if, in the aggregate, they could have a material effect.)

**23.44** The provisions of the Single Audit Act and OMB Circular A-128 encompass internal control structure policies and procedures relevant to an audit of an entity's compliance with the specific requirements that are applicable to major programs. The following paragraphs discuss the auditor's consideration of these policies and procedures in an audit of compliance with requirements applicable to major federal financial assistance programs. Paragraphs 23.25 through 23.34 specifically address subrecipient considerations.

**23.45** In satisfying the internal control provisions of the Single Audit Act and OMB Circular A-128, the auditor should obtain an understanding of the design of relevant internal control structure policies and procedures and whether they have been placed in operation. This understanding should be sufficient to plan the audit of compliance, enabling the auditor to—

- a. Identify the types of potential material noncompliance.
- b. Consider matters that affect the risk of material noncompliance.
- c. Design effective tests of compliance with requirements applicable to major federal financial assistance programs.

**23.46** OMB Circular A-128's requirement to "test whether these internal control systems are functioning in accordance with prescribed procedures" involves performing tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance. Procedures performed to obtain an understanding of the internal control structure may be considered tests of controls if they provide evidential matter about the effectiveness of the design and operation.

**23.47** In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total projected costs questioned for each major federal financial assistance program (hereafter referred to as *likely questioned costs*), not just the questioned costs specifically identified (hereafter referred to as *known questioned costs*). When using audit sampling, as defined in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), in testing compliance, the auditor projects the amount of known questioned costs identified in the sample to the items in the major federal financial assistance program from which the sample was selected.

## **Audit Sampling for Major Federal Financial Assistance Programs**

**23.48** Although the Single Audit Act and OMB Circular A-128 do not require statistical sampling, a representative number of transactions should be selected from each major federal financial assistance program. Auditors

should use professional judgment in determining methods of sample selection. Sample sizes for major programs should be sufficient for the auditor to express an opinion on compliance with applicable laws and regulations relative to each major program.

**23.49** The objectives of auditing procedures for federal financial assistance are to provide sufficient, competent evidential matter to reasonably assure the detection of noncompliance with specific requirements applicable to major federal financial assistance programs and to enable the auditor to issue a report containing either an opinion on compliance with these requirements or a statement that such an opinion cannot be expressed. (The testing to attain those objectives is substantive.) Based on the auditor's assessment of control risk in the consideration of the internal control structure policies and procedures and performance of tests of controls, the auditor should select sample sizes that will provide sufficient evidence for a conclusion on the government's compliance with the specific requirements applicable to *each* major program. The auditor's professional judgment should be used when selecting sample sizes. However, when exercising that judgment, the auditor should be aware that small sample sizes with a low dollar value from a large population may not be sufficient to enable the auditor to express an opinion concerning compliance.

**23.50** OMB Circular A-128 requires that a representative number of transactions be selected from each major program, but does not require that separate samples be used for each major program. Experience has shown, however, that it is generally preferable to select separate samples from each major program, since a separate sample clearly provides evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a manner to clearly indicate (a) that a representative number was selected from each major program and (b) that the results of tests of such samples, together with other audit evidence, is sufficient to support the opinion on each major program's compliance with the specific requirements.

**23.51** If the auditor determines that the likely questioned costs are material to the individual program, the auditor's report should be modified as discussed in paragraph 24.19.

**23.52** Auditors also have the responsibility of assessing how the actual and projected error noted in the testing of the federal financial assistance programs affects the GPFS. When the auditor uses sampling techniques, he or she should refer to SAS No. 39.

## Nonmajor Program Testing

**23.53** OMB Circular A-128 requires transactions selected from nonmajor federal financial assistance programs to be tested for compliance with federal laws and regulations that apply to such transactions. This requirement recognizes that, in connection with the audit of the financial statements or the consideration of the internal control structure over federal financial assistance programs, the auditor may have selected for testing transactions from federal financial assistance programs other than major programs. For example, the selection of nonmajor program transactions may occur during an auditor's entity-wide test of payroll or disbursement transactions. If the auditor has selected such transactions, they should be tested for compliance with the spec-

ific requirements that apply to the individual transactions and reported on in accordance with example A.24, “Single Audit Unqualified Report on Compliance With Specific Requirements Applicable to Nonmajor Federal Financial Assistance Program Transactions,” in appendix A, “Illustrative Auditor’s Reports.” If the auditor did not select any nonmajor transactions in the entity-wide audit, the report is not required to be issued.

**23.54** When nonmajor transactions are selected, the requirements for which compliance should be tested relate to the allowability of the program expenditure and the eligibility of the individuals or groups to whom the entity provides federal financial assistance, as shown in the following examples:

- If an auditor selected a payroll transaction that was charged to a nonmajor program, he or she should determine that the position could reasonably be charged to that program and that the individual’s salary was correctly charged to it. The auditor is not required to test the transaction for compliance with the general requirements, including compliance with the Hatch Act (political activity).
- If the auditor selected a travel claim that was charged to a nonmajor program, he or she should examine evidence indicating whether the person who performed the travel worked on the program, whether the purpose of the travel was related to the program, whether administrative travel was an allowable charge to the program, and whether the travel allowances were within administratively prescribed limits. The auditor is not required to test the transactions for compliance with the general requirements, including compliance with relocation or cash management limitations.
- If the auditor selected a program-related payment made directly to an individual or organization, he or she should determine whether the payment was for the purpose intended by the program and for allowed services, and whether the individual or organization was eligible. The auditor is not required to test for compliance with the general requirements, including civil rights and cash management.

## General Compliance Requirements

**23.55** The OMB’s A-128 Compliance Supplement, which provides guidance for implementation of OMB Circular A-128, identifies nine general requirements that “involve significant national policy and for which failure to comply could have a material impact on an organization’s financial statements including those prepared for federal programs. Accordingly, these compliance requirements shall be included as part of every audit of state, local, and Tribal government that involves federal financial assistance whether or not the government has a major program.” The general requirements may or may not be laws and regulations that have a direct and material effect on the determination of financial statement amounts. Thus, the auditor should evaluate each general requirement based on the circumstances of the engagement to determine whether a particular requirement relates more to the laws and regulations described in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317) that have an indirect effect on the financial statements than to those that have a direct and material effect on the determination of financial statement amounts.

**23.56** The A-128 Compliance Supplement identifies the following nine requirements as general requirements that must be tested as part of all single audits:

- a. Political activity
- b. Davis-Bacon Act (construction contracts)
- c. Civil rights
- d. Cash management
- e. Relocation assistance and real property acquisition
- f. Federal financial reports
- g. Allowable costs/cost principles
- h. Drug-Free Workplace Act
- i. Administrative requirements

Suggested audit procedures for testing compliance with these general requirements are included in the A-128 Compliance Supplement. It is possible that testing of certain general requirements may not be required. For example, if there are no construction-type grants, Davis-Bacon compliance testing would not be applicable.

### **Political Activity**

**23.57** The Hatch Act and the Intergovernmental Personnel Act of 1970, as amended, specify that federal funds cannot be used for partisan political activity of any kind by any person or organization involved in the administration of federally assisted programs. The term *partisan political activity* is not defined.

### **Davis-Bacon Act**

**23.58** When required by applicable legislation, construction programs are required to follow the provisions of this act, which, in general, requires the wages of laborers and mechanics employed by contractors of federally funded projects to be no lower than the prevailing regional wage rate as established by the Secretary of Labor.

### **Civil Rights**

**23.59** Federal financial assistance programs provide that no person shall be excluded from participation in, or be subjected to discrimination in, any program funded, in whole or in part, by federal funds because of race, color, national origin, age, or handicap. Discrimination on the basis of sex or religion is also prohibited in some programs.

### **Cash Management**

**23.60** Grantee financial management systems should include procedures to minimize the time elapsed between the transfer of funds from the U.S. Treasury and the disbursement of funds by the grantee. Many grantees receive funds through a letter-of-credit arrangement with the federal grantor agency. Cash should be withdrawn only in amounts necessary to meet immediate needs or to cover program disbursements already made. Advances made to a subrecipient should conform to these standards of timing and amount as if the funding were received directly from a federal agency. These requirements are consistent with the Federal Cash Management Improvement Act.

### **Relocation Assistance and Real Property Acquisition**

**23.61** Federal financial assistance programs may require the acquisition of property by a public agency and subsequent displacement of households and businesses. Grant recipients acquiring property in the administration of federal aid are required to carry out certain actions systematically (for example, appraise property in the presence of the owner, review appraisals, set price, and

negotiate settlements). Similarly, when displacements (relocations) are involved, the recipient should provide assistance systematically (for example, assure that replacement housing meets acceptable standards and maintain records on all acquisitions and displacements).

## Federal Financial Reports

**23.62** In connection with tests of compliance with applicable laws and regulations, OMB Circular A-128 states that “the auditor shall determine whether the federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the general-purpose or basic financial statements have been prepared” (paragraph 8(a)(2)(b)). This requirement has generally been interpreted to mean that federal financial reports are traceable to the recipient’s financial records—that is, they are not based on estimates.

**23.63** The OMB’s Common Rule, presented herein as appendix F, discusses the following required financial reports that apply to most of the federal financial assistance programs:

- a. *Financial Status Report (SF 269)*—Reports status of funds for all nonconstruction programs
- b. *Request for Advance or Reimbursement (SF 270)*—Requests funds for nonconstruction programs when advance letter-of-credit or predetermined advance payments are not used
- c. *Outlay Report and Request for Reimbursement for Construction Programs (SF 271)*—Requests reimbursements and reports status of funds for construction programs
- d. *Federal Cash Transactions (SF 272)*—Reports cash transactions and balances for grantees receiving cash by a letter of credit or treasury check, although a number of federal programs mandate additional financial reports, to which the auditor should be alert

**23.64** Treasury Circular 1075 lists two alternative cash management reports, one of which applies to each program financed through letters of credit. These reports are (a) Request for Payment on Letter of Credit and Status of Funds Report (SF183) and (b) Payment Voucher on Letter of Credit (TFS 5401).

**23.65** Certain federal agencies have received OMB approval to adapt these reports or require other financial reports to meet their particular program needs. These additional reports would appear as specific requirements for the affected programs.

**23.66** Regardless of their type and how frequently they are filed, federal financial reports provide the federal grantor agency with important financial data concerning the program. This financial data is necessary for monitoring the funds allocated to recipients and for planning for future funding. Consequently, the auditor should become familiar with the federal reports the recipient is required to file and should review the reports for completeness.

## Allowable Costs/Cost Principles

**23.67** OMB Circular A-87, *Cost Principles for State and Local Governments*, establishes principles and standards for determining costs applicable to grants, contracts, and other agreements. A cost is allowable for federal reimbursement only to the extent of benefits received by federal awards and its conformance with the general policies and principles stated in OMB Circular A-87. To be eligible for federal reimbursement, costs (both direct and indirect) should meet the following ten basic criteria:

- a. They should be necessary and reasonable for proper and efficient performance and administration of the federal awards.
- b. They should be allocable to federal awards under the provisions of OMB Circular A-87.
- c. They should be authorized or not prohibited under state or local laws or regulations.
- d. They should conform to any limitations or exclusions set forth in OMB Circular A-87, federal laws, terms and conditions of the federal awards, or other governing regulations as to types or amounts of cost items.
- e. They should be consistent with policies, regulations, and procedures that apply uniformly to both federal awards and other activities of the governmental unit.
- f. They should be accorded consistent treatment. A cost may not be assigned to a federal award as a direct cost if any other cost incurred for the same purpose in like circumstances has been allocated to the federal award as an indirect cost.
- g. They should be determined in accordance with GAAP, except as otherwise noted in OMB Circular A-87.
- h. They should not be included as a cost or used to meet cost-sharing or matching requirements of any other federal award in either the current or a prior period, except as specifically provided by federal law or regulation.
- i. They should be net of all applicable credits.
- j. They should be adequately documented.

**23.68** The cost principles governing the allowability of both direct and indirect costs under government awards are set forth in OMB Circular A-87. A synopsis of Circular A-87 is included in appendix E, "OMB Circulars That Address Management of Federal Assistance Programs Applicable to State and Local Governments." The federal financial assistance program transactions selected by the auditor should be reviewed to determine whether the costs meet the criteria of OMB Circular A-87.

**23.69** Indirect costs are defined as (a) costs incurred for a common or joint purpose benefiting more than one cost objective and (b) costs not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved. Indirect costs may apply to other departments within the organization in supplying goods, services, and facilities. In addition, minor direct costs may be considered to be indirect costs for practical reasons.

**23.70** To be eligible for reimbursement under federal programs, indirect costs must be allocated in conformity with an indirect cost allocation plan prepared in accordance with OMB Circular A-87 or other similar OMB directives. In rare cases in which indirect costs cannot be allocated equitably, the federal grantor agency may provide for a negotiated indirect rate in lieu of allocated indirect costs. Also, for services provided by state or local agencies other than the grantee agency, a standard rate for direct labor may be allowed in lieu of computing actual indirect costs.

**23.71** All state and many large local governments are required to submit their indirect cost plans to a designated federal cognizant agency for approval. Most local governments are not required to submit their indirect cost plans to a cognizant agency for approval; however, a cognizant agency may request them.



**23.72** The auditor should consider examining supporting documentation to determine whether—

- a. The costs, bases, and methods of allocating costs are in accordance with guidelines provided in OMB Circular A-87 or a plan that has been approved by the federal government.
- b. The same costs are not treated both as indirect costs and charged directly to projects.
- c. Statistical data—for example, square footage, population, and salaries—included in the bases are current and reasonable.
- d. The costs are reasonable in amount and they are properly allocable.
- e. The costs were incurred within the period under review.

**23.73** If the auditor detects errors in an indirect cost plan, he or she should discuss those errors with the appropriate level of management. Such errors may include, but are not limited to, mathematical inaccuracies, improper application of cost accounting practices, other factors affecting the calculated indirect cost rate, or misuse of facts that existed at the time the plan was prepared.

**23.74** A deficient indirect cost plan or errors in the application of indirect cost principles can materially affect a major federal financial assistance program, or federal financial reports if indirect costs are charged to the award. Such deficiencies or errors, including their effect on the programs, should be included in the schedule of findings and questioned costs accompanying the auditor's compliance report.

### **Drug-Free Workplace**

**23.75** All grantees receiving grants (including cooperative agreements) *directly* from any federal agency are required to certify that they will provide a drug-free workplace as a precondition of receiving a grant from a federal agency. All grantees, except states, are required to make this certification for all grants. States (including state agencies) may elect to make an annual certification to each federal agency from which they obtain financial assistance. This requirement also applies to contractors that have contracts of \$25,000 or more with the federal government. The requirement does not apply to pass-through assistance unless the subgrantor (primary recipient) requires compliance with Drug-Free Workplace Act requirements, even though the federal government does not make this requirement.

### **Administrative Requirements**

**23.76** The Common Rule contains various administrative requirements with which state and local governments must comply. The Common Rule requirements apply to federal assistance in the form of grants and cooperative agreements and do not cover other types of assistance such as block grants, loans, loan guarantees, and entitlements. Federal assistance in the form of entitlements is subject to the standard administrative requirements of the federal grantor agency. Current administrative requirements for state and local government hospitals and colleges and universities are covered by OMB Circular A-110, and cost principles for colleges and universities are covered by OMB Circular A-21.

**23.77 Common Rule.** The auditor should obtain an understanding of the internal control structure, assess control risk, and test internal control structure policies and procedures relative to the provisions of subpart C of the Common Rule. See appendix F for the Common Rule. Because certain provisions of the Common Rule are incorporated into the General and Specific Com-

pliance Requirements sections of the A-128 Compliance Supplement, they do not need to be addressed separately. For major programs (and those nonmajor programs tested under the 50 percent rule), however, the auditor should obtain an understanding of the internal control structure, assess control risk, and test internal control structure policies and procedures relative to the material provisions of the Common Rule addressed in the General and Specific Requirements. Because application of the Common Rule to specific programs will vary, the auditor may wish to consult with the cognizant agency on its application, particularly for major programs not covered in the A-128 Compliance Supplement. For programs exempt from the Common Rule, the auditor may wish to consult with the cognizant agency, the applicable federal regulations, or other sources for applicable internal control elements.

**23.78** Three administrative requirements—cash management, financial reporting, and cost principles—are explicitly included among the general requirements. The A-128 Compliance Supplement advises auditors that certain other administrative requirements from subpart C of the Common Rule may have a material effect on the federal financial assistance programs and may, therefore, be included among the following general requirements addressed in an audit of federal financial assistance programs: (a) program income, (b) procurement, and (c) subgrants. The auditor should exercise professional judgment in determining if other administrative requirements are relevant in an audit of federal financial assistance.

## Testing General Requirements

**23.79** The A-128 Compliance Supplement includes suggested procedures that can be performed to test the entity's compliance with the general requirements; however, the use of the A-128 Compliance Supplement is recommended, not required. As a result of performing these procedures, the auditor expresses positive assurances on the items tested for compliance and negative assurances on items not tested. As the Single Audit Act and OMB Circular A-128 have been implemented, it has become generally accepted that the nature of these procedures is sufficient to satisfy the requirements of the Act and Circular A-128 with respect to the general requirements. In performing an audit under the Single Audit Act and OMB Circular A-128, the auditor should test compliance with the general requirements regardless of whether the government being audited has any major programs. Determining the extent of any tests of compliance with the general compliance requirements is a matter of professional judgment. Among other matters the auditor considers are the extent of any tests of controls over compliance with the general requirements and specific testing performed for major programs. If the government being audited has no major programs, the auditor should consider whether his or her tests of controls over compliance with the general requirements provide evidence that would also support a report on compliance. If the tests of controls do not provide sufficient evidence to support a report on compliance, additional testing on the general requirements would need to be performed.

**23.80** In the introductory comments to the general requirements in the A-128 Compliance Supplement, the OMB states that several statutory and regulatory requirements are applicable to all or most federal financial assistance programs, that they involve significant national policy, and that failure to comply with those requirements could have a material impact on a government's financial statements, including those prepared for federal programs.

**23.81** When instances of noncompliance with general requirements are identified and can be quantified, materiality is generally assessed at the pro-

gram (or programs) level to which the noncompliance relates, and a determination to modify the auditor's report should be made at that level. However, when the noncompliance is not quantifiable (for example, the failure to adopt a drug-free workplace policy), materiality is generally assessed at the GPFS level, that is, the auditor should consider the effect of any contingent liability in accordance with FASB Statement No. 5, *Accounting for Contingencies*. See also paragraph 21.28.

## Client Representations

**23.82** GAAS require the auditor to obtain written representations from management. Footnote 9 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.10, footnote 9), states that the auditor should obtain written representations from management about matters related to federal financial assistance as part of compliance audits. Therefore, in addition to the management representations discussed in chapter 17, "Concluding the Audit," single audits should include representations concerning the identification and completeness of federal financial assistance receipts and expenditures, representations concerning compliance with applicable laws and regulations, and identification of known instances of noncompliance. The auditor should obtain written representations from management as part of an audit conducted in accordance with the Single Audit Act and OMB Circular A-128. The following are specific written representations ordinarily obtained by the auditor.

- a. Management has identified in the Supplementary Schedule all assistance provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.
- b. Management has identified the requirements governing political activity, the Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, and drug-free workplace, as well as administrative requirements over federal financial assistance.
- c. Management has identified the requirements governing the types of services allowed; eligibility; matching, level of effort, or earmarking; reporting (include any special provisions); claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the Supplementary Schedule.
- d. Management has complied with reporting requirements in connection with federal financial assistance.
- e. Information presented in federal financial reports and in claims for advances and reimbursements is supported by the books and records from which the basic financial statements have been prepared.
- f. Amounts claimed or used for matching were determined in accordance with OMB Circular A-87, *Cost Principles for State and Local Governments*, and with the Common Rule.
- g. Management has monitored subrecipients to determine whether the subrecipients have expended financial assistance in accordance with applicable laws and regulations and have met the requirements of OMB Circular A-128 or OMB Circular A-133, whichever is applicable.

- h.* Management has taken appropriate corrective action on a timely basis after receipt of a subrecipient's auditor's report that identifies noncompliance with federal laws and regulations.
- i.* Management has considered the results of subrecipients' audits and made any necessary adjustments to the entity's own books and records.
- j.* Management has identified and disclosed to the auditor all amounts questioned and known noncompliance with requirements that could have a material effect on a major federal financial assistance program.

**23.83** Management's refusal to furnish written representations may constitute a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on compliance with the specific requirements. Furthermore, the auditor should consider the effects of management's refusal on his or her ability to rely on other management representations.

## **Nonmajor Transactions**

**23.84** The auditor should review transactions selected during tests of the internal control structure and the audit of the GPFS to identify nonmajor program transactions. Each nonmajor program transaction selected should be tested as described in paragraphs 23.53 and 23.54.

## Chapter 24

# ***Reporting Under the Single Audit Act and OMB Circular A-128***

### **Introduction**

**24.01** The auditor's reporting responsibility in audits of federal financial assistance is driven by the three levels of auditing standards and requirements that apply: GAAS, *Government Auditing Standards*, and the Single Audit Act and OMB Circular A-128. They expand the level of auditor responsibility from reporting on an entity's financial statements to reporting on its internal control structure and compliance with laws and regulations. To satisfy this increased responsibility, additional audit reports are required. Exhibit 24.1 displays the levels of reporting and the different reports that are required for meeting the provisions of OMB Circular A-128.

## Exhibit 24.1

## Single Audit Reporting Matrix\*

<u>Report</u>	<u>Type of Report</u>	<u>Required by</u>		
		<u>GAAS</u>	<u>Government Auditing Standards</u>	<u>Single Audit Act / OMB Circular A-128</u>
General-purpose financial statements	Opinion	1-15	1-15	1-15
Internal control structure based on GAAS procedures <sup>†</sup>	SAS No. 60 type		25	25
Compliance based on GAAS procedures <sup>†</sup>	Results of procedures		17	17
Federal financial assistance: Supplementary Schedule of Federal Financial Assistance	In relation to general-purpose financial statements			16
Compliance with general requirements	Positive and negative			23
Compliance with specific requirements: Major program	Opinion			18-22
Nonmajor (when selected)	Positive and negative			24
Internal control structure related to federal financial assistance	Results of procedures			26

(Continued)

\* This matrix summarizes the auditor's reports required by *Government Auditing Standards*, the Single Audit Act, and OMB Circular A-128. The numbers refer to examples in appendix A, "Illustrative Auditor's Reports." All reports should be tailored to individual circumstances (a report on illegal acts is required only when instances are detected).

<sup>†</sup> *Government Auditing Standards*, paragraphs 5.15 and 5.16, permits auditors to report on the internal control structure and compliance with laws and regulations in the report on the financial statements or in separate reports.

<u>Report</u>	<u>Type of Report</u>	<u>Required by</u>		
		<u>GAAS</u>	<u>Government Auditing Standards</u>	<u>Single Audit Act / OMB Circular A-128</u>
Irregularities and illegal acts (issued only when instance are detected)	See discussion in SAS No. 54 and chapter 5, "Testing and Reporting on Compliance With Laws and Regulations"		X	X

## Report on General-Purpose Financial Statements

**24.02** When reporting on an audit of the GPFS performed in accordance with GAAS, the auditor is required to report whether the financial statements are presented fairly in conformity with GAAP. Although the Single Audit Act and OMB Circular A-128 do not require the financial statements to be presented in conformity with GAAP, they require the auditor to determine and report on whether they are in conformity with GAAP.<sup>20</sup> When assessing whether the GPFS are fairly presented, the auditor considers the requirements of SAS No. 53, *Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), and SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), as they relate to noncompliance with laws or regulations that could materially affect the GPFS. *Government Auditing Standards* state that when the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for a *Government Auditing Standards* audit, the auditor is required to state that the audit was performed in accordance with *Government Auditing Standards*. However, *Government Auditing Standards* do not prohibit auditors from issuing a separate report on the financial statements in accordance with the requirements of GAAS if the financial statement audit is for purposes other than to comply with requirements calling for a *Government Auditing Standards* audit.

## Government Auditing Standards Reports

**24.03** In performing an audit of an entity's GPFS in accordance with *Government Auditing Standards*, the auditor is required, in addition to reporting on whether these statements are fairly presented, to report on compliance with laws and regulations (see chapter 5, "Testing and Reporting on Compliance With Laws and Regulations") and to report on the entity's internal control structure (see chapter 4, "Internal Control Structure"). *Government Auditing Standards*, paragraphs 5.15 and 5.16, permits auditors to report on compliance with laws and regulations and on the internal control structure in the report on the financial statements or in separate reports. As described in exhibit 24.1, each report is based on GAAS procedures (see also paragraphs 5.26 and 5.27 herein).

### Report on the Internal Control Structure Based on an Audit of the General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards*

**24.04** The auditor's report on internal control structure required by *Government Auditing Standards* is based on the auditor's consideration of the internal control structure as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). The report does not express an opinion on the government's internal control structure, but rather describes the extent of work performed as required by SAS No. 55. The report includes the requirements of SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). *Government Auditing Standards* permits the report on the internal control

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<sup>20</sup> For an organization that prepares its basic financial statements in conformity with a basis of accounting other than GAAP, the reporting guidance is found in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623).



structure to be issued in the report on the financial statements or separately. Therefore, the report on the financial statements should either (1) describe the scope of the auditors' testing of internal controls and present the results of those tests or (2) refer to a separate report containing that information. When auditors report on internal controls in the report on the financial statements, they should include an introduction summarizing key findings in the audit of the financial statements and the related internal control work. Auditors should not issue this summary as a stand-alone report. When auditors report separately on controls, the report on the financial statements should state that they are issuing the additional report. *Government Auditing Standards* also states that the report should include a description of reportable conditions as well as separately identify those that are considered material weaknesses. The auditor's report on the internal control structure should contain—

- a. A statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with GAAS and with *Government Auditing Standards* issued by the Comptroller General of the United States.
- c. A statement that the objective of the audit of the financial statements was not to provide an opinion on the internal control structure and that accordingly, no such opinion is expressed.
- d. A statement that the establishment and maintenance of the internal control structure are the responsibilities of management.
- e. An explanation of the broad objectives and inherent limitations of any internal control structure.
- f. A description of the scope of the auditor's work, stating that the auditor obtained an understanding of the design of relevant policies and procedures, determined whether those policies and procedures have been placed in operation, and assessed control risk.
- g. The definition of reportable conditions.
- h. A description of the reportable conditions noted.
- i. The definition of material weakness.
- j. A statement about whether the auditor believes any of the reportable conditions described in the report are material weaknesses, and, if they are, identifies the material weaknesses noted.
- k. If applicable, a statement that other matters involving the internal control structure and its operation were communicated to management in a separate letter.
- l. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.

An example of standard reporting language is presented in example A.25(A), "Report on the Internal Control Structure Based on an Audit of General-Purpose Financial Statements Performed in Accordance with *Government Auditing Standards*," in appendix A, "Illustrative Auditor's Reports," and a modification when there are no material weaknesses and no reportable conditions is shown in example A.25(B), "Report on the Internal Control Structure

Based on an Audit of General-Purpose or Basic Financial Statements Performed in Accordance With *Government Auditing Standards*—No Material Weaknesses When There Are No Reportable Conditions,” in appendix A.

## Single Audit and OMB Circular A-128 Reports

**24.05** In addition to the reporting responsibilities described above, in a single audit the auditor is required to report on the Supplementary Schedule of Federal Financial Assistance (Supplementary Schedule), the entity’s internal control structure for administering federal financial assistance programs, and its compliance with laws and regulations, noncompliance with which could be material to federal financial assistance programs.

### Report on Supplementary Schedule of Federal Financial Assistance

**24.06** This report, required to be issued by OMB Circular A-128, makes specific reference to the audit’s having been performed in accordance with *Government Auditing Standards* and provides assurance on the fair presentation of the Supplementary Schedule in relation to the GPFS. An illustration of this report is provided in example A.16, “Unqualified Opinion on Supplementary Schedule of Federal Financial Assistance,” in appendix A.

### Report on Internal Control Structure Used in Administering Federal Financial Assistance Programs

**24.07** This report addresses the internal control structure policies and procedures used in administering federal financial assistance programs in compliance with laws and regulations. Such report should contain the following elements, as appropriate:

- a. A statement that the auditor has audited the financial statements and a reference to the auditor’s report on the financial statements, including a description of any departure from the standard report
- b. A statement that the auditor has audited compliance with requirements applicable to major federal financial assistance programs and a reference to the auditor’s report on compliance
- c. A statement that the audit was conducted in accordance with GAAS; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-128
- d. A statement that, in planning and performing the audit of the major federal financial assistance programs, the auditor considered the entity’s internal control structure to determine the auditing procedures for purposes of expressing an opinion on compliance with requirements applicable to major federal financial assistance programs and to report on the internal control structure used in administering federal financial assistance programs in accordance with OMB Circular A-128
- e. A statement that the establishment and maintenance of the internal control structure are the responsibilities of management
- f. An explanation of the broad objectives and inherent limitations of any internal control structure
- g. A description of the entity’s significant internal control structure policies and procedures categories considered as part of the auditor’s understanding of the structure

- h.* A description of the scope of the auditor's work stating that the auditor obtained an understanding of the design of relevant policies and procedures and whether those policies and procedures have been placed in operation, and assessed the control risk
- i.* A statement about the percentage of total federal financial assistance expended under major and, if total assistance expended under major federal financial assistance programs is less than 50 percent of total federal assistance expended by the recipient organization during the year under audit, certain nonmajor federal financial assistance programs
- j.* A statement that the auditor performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that the auditor considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each major federal financial assistance program
- k.* A statement that the auditor's procedures were less in scope than would be necessary to render an opinion on internal control structure policies and procedures and a disclaimer of opinion on those policies and procedures
- l.* The definition of reportable conditions
- m.* A description of the reportable conditions noted (These conditions can be included in a separate schedule rather than in the body of the report. The separate schedule can also contain matters pertaining to other audit reports as long as the reportable conditions are labeled as such.)
- n.* The definition of material weakness
- o.* A statement about whether the auditor believes any of the reportable conditions described in the report are material weaknesses and, if they are, that identifies the material weakness noted
- p.* If applicable, a statement that other matters involving the internal control structure and its operation were communicated to management in a separate letter
- q.* A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record

**24.08** In appendix A, examples A.26(A)-(E) illustrate reports on the internal control structure used in administering federal financial assistance programs.

### **Single Audit Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs**

**24.09** Example A.23(A), "Single Audit Unqualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs," in appendix A illustrates the standard report issued related to testing of general requirements for federal financial assistance programs. The

report should cite the general requirements tested and the procedures performed and express positive assurance on items tested and negative assurance on items not tested. Example A.23(B), "Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Material Noncompliance," illustrates the report that is issued when material noncompliance is identified. Example A.23(C), "Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Scope Limitations," illustrates the report that is issued when a scope limitation exists.

**24.10** The basic elements of a report expressing positive and negative assurance on compliance with the general requirements include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement identifying the general requirements tested (see paragraph 23.56 for a listing of general requirements).
- c. A statement that the auditor's procedures were limited to the applicable procedures described in the Compliance Supplement or that describes alternative procedures.
- d. A statement that the auditor's procedures were substantially less in scope than an audit and a disclaimer of an opinion on compliance with the general requirements.
- e. A statement of positive assurance that, with respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the general requirements.
- f. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor's attention that caused him or her to believe that the entity had not complied, in all material respects, with the general requirements.<sup>21</sup>
- g. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs.
- h. A statement that the report is intended for the information of the audit committee, management, and specified legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.
- i. The manual or printed signature of the auditor's firm.
- j. The date of the auditor's report.

### **Single Audit Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs**

**24.11** The report on compliance with the specific requirements applicable to major programs expresses the auditor's opinion on whether the entity complied with the requirements that, if noncompliance occurred, could materially affect any major program. Example A.18(A), "Single Audit Unqualified

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<sup>21</sup> In the event that instances of noncompliance are reported as a result of tests performed, the auditor should consider the extent to which the pervasiveness of reported instances of noncompliance may affect the auditor's ability to express negative assurance with respect to items not tested.

Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs,” in appendix A illustrates the standard report on compliance with specific requirements applicable to major programs. The report identifies the specific requirements tested, including any special tests and provisions. The special tests and provisions may be listed (or otherwise summarized) in the auditor’s report individually or, alternatively, in an attachment to the report. The report also refers to any immaterial instances of noncompliance with specific requirements that are included in the schedule of findings and questioned costs (see paragraph 24.29).

**24.12** The basic elements of the auditor’s report on compliance with specific requirements include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor’s report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the entity’s compliance with the requirements identified in the report was audited. (See chapter 23, “Performing the Audit of Federal Financial Assistance Programs,” paragraph 23.40 for a listing of specific requirements.)
- c. A statement that compliance with the requirements in item *b* is the responsibility of the entity’s management and that the auditor’s responsibility is to express an opinion on compliance with those requirements based on the audit.
- d. A statement that the audit was conducted in accordance with GAAS; *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-128.
- e. A statement that GAAS, *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128 require that the auditor plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to in item *b* occurred.
- f. A statement that an audit includes examining, on a test basis, evidence about the entity’s compliance with the requirements referred to in item *b*.
- g. A statement that the auditor believes that his or her audit provides a reasonable basis for an opinion.
- h. A summary of all instances of noncompliance noted and identification of the amounts questioned or reference to a separate schedule of findings and questioned costs.
- i. A statement that the noncompliance or questioned costs noted were considered in forming an opinion as to whether the entity complied, in all material respects, with the requirements referred to in item *b*.
- j. An opinion as to whether the entity complied, in all material respects, with the requirements referred to in item *b*.
- k. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.

- l. The manual or printed signature of the auditor's firm.
- m. The date of the auditor's report.

**24.13** Auditors are able to express an unqualified opinion only if they have been able to apply all the procedures they consider necessary in the circumstances. Restrictions on the scope of their audit, whether imposed by the client, or by circumstances such as the timing of the auditors' work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require auditors to qualify their opinion or to disclaim an opinion. In such instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor's report. Further, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements.

**24.14** The auditor's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major federal financial assistance program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major federal financial assistance program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance. Example A.19, "Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation," in appendix A illustrates an opinion qualified because of a scope limitation.

**24.15** When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph(s) the reasons why his or her audit did not comply with GAAS, *Government Auditing Standards* issued by the Comptroller General of the United States, or OMB Circular A-128. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any reservations he or she has regarding compliance with applicable laws and regulations. Example A.20, "Single Audit Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation," in appendix A illustrates a report disclaiming an opinion resulting from an inability to obtain sufficient competent evidential matter because of a scope limitation.

**24.16** When the audit of an entity's compliance with requirements governing a major federal financial assistance program detects noncompliance with those requirements that the auditor believes have a material effect on that program, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report. Example A.21, "Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Noncompliance," of appendix A illustrates an auditor's opinion that is qualified because of noncompliance with requirements governing federal financial assistance. Example A.22, "Single Audit Adverse Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs," of appendix A is an example of an adverse opinion because of noncompliance with requirements governing federal financial assistance.

## Single Audit Report on Compliance With Requirements Applicable to Nonmajor Federal Financial Assistance Program Transactions

**24.17** Example A.24, “Single Audit Unqualified Report on Compliance With Specific Requirements Applicable to Nonmajor Federal Financial Assistance Program Transactions,” in appendix A illustrates the standard report issued with regard to transactions, if any, from nonmajor federal financial assistance programs selected during tests performed in connection with the GPFS audit and the review of the internal control structure used to administer federal financial assistance programs. The auditor should express positive assurance on items tested and negative assurance on items not tested.

**24.18** The basic elements of the auditor’s report on compliance with requirements applicable to nonmajor federal financial assistance program transactions include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor’s report on the financial statements including a description of any departure from the standard report.
- b. A statement identifying the requirements tested.
- c. A statement that the procedures for testing compliance with the specific requirements applicable to nonmajor federal financial assistance programs are required by OMB Circular A-128.
- d. A statement that these procedures were performed in connection with an audit of the financial statements and with the consideration of the internal control structure over federal financial assistance programs, as required by OMB Circular A-128.
- e. A statement that the auditor’s procedures were substantially less in scope than an audit and a disclaimer of an opinion on compliance with the requirements identified.
- f. A statement of positive assurance that, with respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with specific requirements identified.<sup>22</sup>
- g. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor’s attention that caused him or her to believe that the entity had not complied, in all material respects, with the specific requirements identified.<sup>23</sup>
- h. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs.
- i. A statement that the report is intended for the information of the audit committee, management, and specified legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.
- j. The manual or printed signature of the auditor’s firm.
- k. The date of the auditor’s report.

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<sup>22</sup> For purposes of reporting on compliance with requirements applicable to nonmajor federal financial assistance programs, the auditor should consider material noncompliance to be the same as “material instances of noncompliance” which is defined in chapter 5, paragraph 5.35 herein.

<sup>23</sup> See footnote 22.

## Other Compliance Reporting Matters

**24.19** Testing an entity's compliance with general and specific compliance requirements requires that auditors make a comply/noncomply decision about an entity's adherence to those laws and regulations. OMB Circular A-128 requires that all instances of noncompliance identified in tests of compliance be reported, regardless of materiality or of the ultimate resolution of the noncompliance. The following situations could occur when the auditor is reporting on the results of compliance testing:

- a. If appropriate evidence cannot be examined to support the comply/noncomply decision, a scope limitation would exist and the audit report would need to be modified. (For illustrations of such reports, see examples A.19 and A.23(C) in appendix A.) However, if the auditor concludes that compliance with a requirement cannot be reasonably estimated or measured, the auditor would be precluded from issuing an opinion on compliance with a specific requirement. (See example A.20 in appendix A.)
- b. If the auditor examined sufficient evidence to support a noncompliance finding, a modification to the auditor's report on compliance should be considered in light of several factors, including the number and type of instances of noncompliance, determinability of questioned costs, and materiality of questioned costs. If, after considering these factors, the auditor—
  - Believes the instance of noncompliance has a material effect on a federal program, the auditor's report should be modified—qualified or adverse. (See examples A.21, A.22, and A.23(B) in appendix A.)
  - Cannot determine whether the instance of noncompliance could have a material effect on the program, the report on compliance should state that noncompliance occurred and refer to the Schedule of Findings and Questioned Costs where the noncompliance is further described. The description of the noncompliance in the Schedule of Findings and Questioned Costs should indicate that the instance of noncompliance cannot be reasonably estimated and that the ultimate resolution is not known. (See example A.21 in appendix A.) The auditor should also consider the effect of the noncompliance on the general-purpose financial statements and modify the report on those statements as necessary in accordance with SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508).

## Other Communications

**24.20** Other communications that should be made include—

- Oral or written communication with management pertaining to deficiencies in internal controls that are not reportable conditions or other matters involving the internal control structure. If written, the letter should be referred to in the reports on the internal control structure. (See examples A.25(A) through A.26(E) in appendix A.)
- A written report on fraud, abuse, or an illegal act or on indications of such acts, when discovered. (See chapter 5, paragraphs 5.40 and 5.41.)



## Dating of Reports

**24.21** Since the report on the Supplementary Schedule indicates that the auditor is reporting “in relation to” the GPFS, it should carry the same date as the report on these statements. Furthermore, since the reports on compliance and internal control structure, as required by *Government Auditing Standards*, relate to the GPFS and are based on GAAS audit procedures performed, they should also be dated the same.

**24.22** Ideally, the reports required by the Single Audit Act and OMB Circular A-128 should also be dated the same as the other reports, but they often carry a later date because some of the audit work to satisfy the single audit requirements may be done subsequent to the work on the GPFS. In any case, when issuing the report on the GPFS, the auditor should consider the effect of any material contingent liabilities resulting from possible noncompliance in accordance with FASB Statement No. 5, *Accounting for Contingencies*. If, after issuing the report on the general-purpose financial statements, the auditor discovers instances of noncompliance that materially affect the statements, he or she should follow the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 561).

## Other Auditors

**24.23** When more than one independent auditor is involved in an audit performed under the Single Audit Act and OMB Circular A-128, the auditor should refer to guidance in SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 12 and 13 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.12 and .13), regarding an opinion on financial statements based in part on the report of another auditor. An illustration of a report on the general-purpose financial statements with reference to the audit of a component unit or fund by another auditor is provided in examples A.12(A) through A.13 in appendix A.

**24.24** If the audit of federal financial assistance did not encompass the entirety of the government's operations, the operations that are not included should be identified in a separate paragraph following the first paragraph of the reports on federal financial assistance. An example of such a paragraph follows:

The City's general-purpose financial statements include the operations of the [identify component unit or department], which received \$XXX in federal financial assistance during the year ended June 30, 19X1. Our audit, described below, did not include the operations of [identify component unit or department] because [state reason for omission, such as because the component unit engaged other auditors to perform an audit in accordance with the Single Audit Act of 1984].

## Distribution of Reports

**24.25** The recipient is responsible for submitting copies of reports to each federal department or agency that provides federal financial assistance to it. In addition, the recipient is responsible for submitting a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings. Each agency may specify, in its program regulations or in the award, the distribution point for the single audit reports. Recipients of \$100,000 or more in federal funds are required to submit a copy of the audit report to the

central audit report clearinghouse, which is located at the following address: Bureau of the Census, Data Preparation Division, 1201 E 10th Street, Jeffersonville, IN 47132. Subrecipients are also required to submit copies to recipients that provided them with federal financial assistance funds.

**24.26** The auditor should be alert to situations in which the prime recipient has specified more stringent audit delivery time frames on subrecipients than specified in OMB Circular A-128.

**24.27** Although the required reports may be issued simultaneously to the recipient by the auditor, such delivery may not be practicable and the auditor should consider this when planning the audit. If simultaneous delivery is not possible, the auditor could deliver the report on the entity's financial statements and separately deliver the balance of the reports as one bound report. Separate delivery of each or part of the balance of the reports is not recommended because this may cause confusion, which, in turn, may result in the full complement of reports not being delivered to grantors. See paragraphs 24.21 and 24.22 for guidance on the dating of reports.

**24.28** OMB Circular A-128 requires the following:

- a. The reports shall be made available by the state or local government for public inspection within thirty days after the audit is completed and the audit reports are issued by the auditor to the recipient government audited.
- b. Reports shall be submitted by the auditor to the recipient government audited and to those requiring or arranging for the audit. In addition, the recipient shall submit copies of the report to each federal department or agency that provides federal assistance funds to the recipient. Subrecipients shall submit copies to recipients that provided them federal financial assistance funds. The reports shall be sent to federal grantors within thirty days after the audit is completed and the audit reports are issued by the auditor, but no later than one year after the end of the audit period, unless a longer period is agreed to with the cognizant agency.

## Schedule of Findings and Questioned Costs

**24.29** OMB Circular A-128 requires that the auditor's report on compliance contain a summary of all findings of noncompliance and an identification of total amounts questioned, if any, for each federal financial assistance award as a result of noncompliance. Auditors should include all findings regardless of materiality. For example, the auditor may conclude that a quantified finding would not have a material effect on a major program; however, because all noncompliance findings are reported, the instance of noncompliance may be reported. The auditor may discover a finding where the recipient could have been reimbursed for more than claimed; in this instance, a *negative* finding should be reported. See paragraphs 24.37 through 24.42 for a discussion of the schedule of findings and questioned costs.

## What Should Be Reported

**24.30** In an audit of federal financial assistance in accordance with the Single Audit Act and OMB Circular A-128, findings consist of instances of noncompliance with general or specific requirements applicable to federal fi-

nancial assistance programs. All instances of noncompliance with these requirements should be reported in the appropriate auditor's report or identified in the schedule of findings and questioned costs.

**24.31** The auditor should also report all questioned costs related to federal financial assistance programs. The term *questioned costs* is defined in the Inspector General Act Amendments of 1988 as one of the following:

- a. An alleged violation of a provision of law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds
- b. A finding that, at the time of the audit, such cost is not supported by adequate documentation
- c. A finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable

### Criteria for Reporting Questioned Costs

**24.32** The criteria established for determining or questioning costs to be reported in the compliance report vary from one agency to another. Many of the criteria are imposed by Congress at the time the programs are authorized and funds are provided; other criteria are established through agency regulations, such as OMB Circular A-87. In general, the criteria for determining and reporting questioned costs are as follows:

- a. *Unallowable costs*—Certain costs specifically unallowable under the general and special award conditions or agency instructions (including, but not limited to, pregrant and postgrant costs and costs in excess of the approved grant budget either by category or in total)
- b. *Undocumented costs*—Costs charged to the grant for which adequate detailed documentation does not exist (for example, documentation demonstrating their relationship to the grant or the amounts involved)
- c. *Unapproved costs*—Costs that are not provided for in the approved grant budget, or for which the grant or contract provisions or applicable cost principles require the awarding agency's approval, but for which the auditor finds no evidence of approval
- d. *Unreasonable costs*—Costs incurred that may not reflect the actions a prudent person would take in the circumstances, or costs resulting from assigning an unreasonably high valuation to in-kind contributions

**24.33** The Single Audit Act and OMB Circular A-128 do not require that the auditor's report on compliance include a projection of questioned costs to the universe of federal financial assistance programs, nor do they require that the auditor expand the scope of an audit to determine with greater precision the effect of any questioned cost. However, there may be some instances in which the circumstances of specific questioned costs could be the basis for the auditor, the grantor, or both, to question all costs charged to a federal program or programs. For example, if eligibility requirements, matching, or cost-sharing conditions have not been met by the recipient in certain circumstances, the entire amount expended in connection with affected programs may be questioned. If such questioned costs are subsequently disallowed by the federal agency, the entire amount may be required to be refunded by the recipient. If

the recipient has not recorded or disclosed a liability or contingent liability for such refunds, the auditor should consider the effect of the liability or contingent liability on the GPFS. FASB Statement No. 5, as amended and interpreted, provides guidance on accruing and disclosing contingent liabilities.

**24.34** Management is responsible for directing the corrective action and resolving recommendations associated with findings and questioned costs. However, chapter 4, paragraph 4.10 of *Government Auditing Standards* requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. In practice, this is generally done as part of the schedule of findings and questioned costs or in a schedule of audit resolution matters. See paragraph 3.36 for further discussion of the additional standard under *Government Auditing Standards* concerning audit follow-up.

**24.35** Noncompliance that does not involve federal financial assistance (such as violations of state or local laws) and that may be noted during the financial statement audit generally should not be included in the schedule of findings and questioned costs. Rather, those instances of noncompliance should be reported in the auditor's report on compliance under *Government Auditing Standards* (see chapter 5).

**24.36** Reportable conditions and material weaknesses in internal controls over federal financial assistance may be closely related to noncompliance and questioned costs. To clarify the relationship between internal control and compliance findings, it may be effective to include reportable conditions and material weaknesses in the schedule of findings and questioned costs. In that case, the report on internal controls over federal financial assistance may refer to that schedule rather than repeat the findings. Reportable conditions and material weaknesses not related to federal financial assistance should be presented in the auditor's report on the internal control structure of the governmental entity based on an audit performed in accordance with *Government Auditing Standards*, not in the schedule of findings and questioned costs.

## Preparation of the Schedule of Findings and Questioned Costs

**24.37** The schedule of findings and questioned costs should be prepared in accordance with relevant reporting standards contained in *Government Auditing Standards*. Those standards address elements of audit findings and place findings, and other report presentation matters, in the proper perspective. Chapter 5, paragraph 5.19, of *Government Auditing Standards* discusses how to do this. In reporting noncompliance, the instances identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate.

**24.38** The schedule of findings and questioned costs should contain a summary of all instances (findings) of noncompliance and should identify total amounts questioned, if any, for each federal financial assistance program. *Government Auditing Standards* (footnote 5 on page 54 and chapter 7, paragraphs 7.17 through 7.23, therein) suggests that well-developed findings, which provide sufficient information to federal, state, and local officials to permit timely and proper corrective action, generally consist of statements of the following:

- The condition (what is)
- Criteria (what should be)
- Effect (the difference between what is and what should be)
- Cause (why it happened)

However, the auditor may not be able to fully develop all of these points, given the scope and purpose of single audits.

**24.39** *Government Auditing Standards* also requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. General practice is for the auditor to include, in a separate section of the schedule of findings and questioned costs (or in a separate schedule or summary), the current-year status of each item in the prior-year schedule; frequently, this is done in a side-by-side summarization. The use of a table may be appropriate to summarize extensive findings.

**24.40** *Government Auditing Standards* (chapter 7, paragraphs 7.38 through 7.42) requires the auditor's report to include views of responsible client officials, as appropriate. The Single Audit Act and OMB Circular A-128 require management to submit to the cognizant agency, along with the single audit reports, a plan for corrective action to remedy any material weaknesses in the internal control structure or material instances of noncompliance found during the audit. Thus, when the auditor identifies material weaknesses or material instances of noncompliance, management will provide comments on those findings. In some circumstances, the corrective action plan may constitute management's formal response.

**24.41** In preparing a schedule of findings and questioned costs that will meet the needs of its users, the auditor should consider the following guidelines:

- a. The findings should be organized so that they can be readily related back to the Supplementary Schedule and should identify the CFDA number to which they relate.
- b. Findings that produce questioned costs should be described completely and clearly so that the program manager can understand the nature of and reason for the noncompliance and can determine the relative magnitude of the finding.
- c. Current-year findings should be distinguished from the discussion of the status of material prior-year findings.
- d. The status of uncorrected material prior-year findings and recommendations should be discussed.
- e. If, as a result of audit inquiries, the auditor becomes aware of audits made by others, the schedule of findings and questioned costs should refer to reports of other auditors or of federal inspectors general that present material findings that remain unresolved. Generally, material findings of other auditors or programmatic reviewers should be summarized in the schedule.

**24.42** A schedule of findings and questioned costs prepared in accordance with the criteria described in this chapter could be organized as follows (see chapter 5, paragraph 5.19, and chapter 7, paragraph 7.19, of *Government Auditing Standards*):

- I. Findings and Questioned Costs  
*Program (by CFDA number)*
  1. Finding
    - a. Condition
    - b. Criteria
    - c. Effect
    - d. Cause
    - e. Recommendation

2. Questioned cost (if any)
- II. Status of Prior-Year Findings
- III. Reference to Material Findings Presented in Reports of Other Auditors or Federal Inspectors General

To assist in presenting findings, the auditor may refer to the AICPA May 1991 Financial Report Survey, *Illustrations of Compliance Findings in Single Audit Reports of Local Government*.

Appendixes

## Appendix A

### *Illustrative Auditor's Reports*

**A.1** This appendix contains examples illustrating the reports required under GAAS, *Government Auditing Standards*, and OMB Circular A-128 in various circumstances. As illustrated in exhibit 24.1, in every organization-wide single audit, auditors must issue the appropriate illustrated reports, modified for the circumstances.

**A.2** *Government Auditing Standards* states that when the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for a *Government Auditing Standards* audit, the auditor is required to state that the audit was performed in accordance with *Government Auditing Standards*. (Example A.1, footnote 2, provides illustrative wording for this reference to *Government Auditing Standards*.) However, *Government Auditing Standards* do not prohibit auditors from issuing a separate report on the financial statements in accordance with the requirements of GAAS if the financial statement audit is for purposes other than to comply with requirements calling for a *Government Auditing Standards* audit.

**A.3** Auditors should modify the example reports as necessary for noncompliance and for other matters specified in professional standards such as scope limitations and departures from GAAP.

**A.4** *Government Auditing Standards* gives auditors the option to report on compliance with laws and regulations and internal controls in the report on the financial statements. If auditors choose this option, *Government Auditing Standards* requires that the "combined" report include an introduction summarizing key findings in the audit of the financial statements and the related compliance and internal control work. Although it may be feasible for auditors to issue such combined reports, auditors should exercise care to assure that the many unique reporting requirements of both GAAS and *Government Auditing Standards* are met. In addition, auditors should be aware that combining reports that are restricted to specified users (i.e., reports on compliance with laws and regulations and internal controls) with a report for general distribution (i.e., report on the financial statements) results in a restriction of all included reports to the specified users. If auditors choose to report on compliance with laws and regulations and internal controls separately, the report on the financial statements should refer to the separate reports. Example A.1, footnote 3, provides illustrative wording for this reference. The examples in this appendix are not combined.

**A.5** Some auditors have followed the practice of issuing combined reports in single audits. Although it may be feasible in some circumstances to combine certain of the reports issued to comply with the Single Audit Act and OMB Circular A-128, auditors should exercise care in issuing such combined reports to assure that the many unique reporting requirements and varying levels of materiality of the Single Audit Act and OMB Circular A-128 are met. Furthermore, the PCIE Desk Review Checklist is designed to review each of the single audit reports. The examples in this appendix are not combined.

**A.6** If the auditor's report on the financial statements contains any departure from the standard report, the reasons for the departure should be described



in the auditor's reports on compliance, internal control, and the schedule of federal financial assistance (for example, see footnote 55, example A.16, "Unqualified Opinion on Supplementary Schedule of Federal Financial Assistance," in this appendix).

**A.7** The following sample auditor's reports illustrate the types of reports to be issued in selected situations. Chapter 18 of this guide includes discussions of certain of the situations and the resulting reports contained herein. For additional guidance the auditor should refer to SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). Examples A.27, "Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23," and A.28, "Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23," illustrate reporting on summary financial information as discussed in chapter 18.

## Examples Included in Appendix A

### ***Example A.1***

Unqualified Opinion on General-Purpose Financial Statements

### ***Example A.2***

Unqualified Opinion on General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data

### ***Example A.3***

Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements, Presented Together With Supporting Schedules Reported on as Supplementary Data

### ***Example A.4***

Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit

### ***Example A.5***

Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity

### ***Example A.6***

Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group

### ***Example A.7***

Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type

<b><i>Example A.8</i></b>	Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity
<b><i>Example A.9</i></b>	Unqualified Opinion on an Enterprise Fund's Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity
<b><i>Example A.10</i></b>	[Deleted as a result of the issuance of SAS No. 79, <i>Amendment to Statement on Auditing Standards No. 58</i> , Reports on Audited Financial Statements.]
<b><i>Example A.11</i></b>	Qualified Opinion on General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity
<b><i>Example A.12(A)</i></b>	Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function, or Activity by Other Auditors
<b><i>Example A.12(B)</i></b>	Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements When One Fund or Component Unit Representing Less Than All of a Fund Type Has Been Audited by Other Auditors
<b><i>Example A.13</i></b>	Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of <i>All</i> of a Fund Type by Other Auditors
<b><i>Example A.14</i></b>	Unqualified Opinion on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles
<b><i>Example A.15</i></b>	Unqualified Opinion on Financial Statements of a Department Constituting Less Than a Fund
<b><i>Example A.16</i></b>	Unqualified Opinion on Supplementary Schedule of Federal Financial Assistance

**Example A.17(A)**

Unqualified Report on Compliance Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards*—No Reportable Instances of Noncompliance

**Example A.17(B)**

Qualified Report on Compliance Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards*—Reportable Instances of Noncompliance

**Example A.18(A)**

Single Audit Unqualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

**Example A.18(B)**

[Deleted as a result of the issuance of SAS No. 79.]

**Example A.19**

Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation

**Example A.20**

Single Audit Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation

**Example A.21**

Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Noncompliance

**Example A.22**

Single Audit Adverse Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

**Example A.23(A)**

Single Audit Unqualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs

**Example A.23(B)**

Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Material Noncompliance

<b><i>Example A.23(C)</i></b>	Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Scope Limitation
<b><i>Example A.24</i></b>	Single Audit Unqualified Report on Compliance With Specific Requirements Applicable to Nonmajor Federal Financial Assistance Program Transactions
<b><i>Example A.25(A)</i></b>	Report on the Internal Control Structure Based on an Audit of General-Purpose Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>
<b><i>Example A.25(B)</i></b>	Report on the Internal Control Structure Based on an Audit of General-Purpose or Basic Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> —No Material Weaknesses When There Are No Reportable Conditions
<b><i>Example A.26(A)</i></b>	Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs
<b><i>Example A.26(B)</i></b>	Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Material Weaknesses When There Are No Reportable Conditions
<b><i>Example A.26(C)</i></b>	Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Tests of Controls Are Performed for Certain Compliance Requirements
<b><i>Example A.26(D)</i></b>	Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—Total Assistance Expended Under Major Programs Is Less Than 50 Percent of Federal Financial Assistance
<b><i>Example A.26(E)</i></b>	Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Major Programs

<i>Example A.27</i>	Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23
<i>Example A.28</i>	Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23

**Example A.1****Unqualified Opinion on General-Purpose Financial Statements<sup>1</sup>****Independent Auditor's Report**

We have audited the accompanying general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>2</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>3</sup>

[Signature]

[Date]

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<sup>1</sup> The financial statements of a component unit should acknowledge that the component unit is a component unit of another government; for example, "We have audited the accompanying general-purpose financial statements of Sample County School District, component unit of Sample County, as of and for the year ended June 30, 19X1." In addition, the notes to the component unit's financial statements should identify the primary government of the financial reporting entity and the component unit's relationship to the primary government. For reporting on the financial statements of a primary government that omit the financial data of each component unit, see the Audit and Accounting Guide *Audits of State and Local Governmental Units*, example A.4, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit."

<sup>2</sup> When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, insert the phrase "and *Government Auditing Standards* issued by the Comptroller General of the United States."

<sup>3</sup> When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, a paragraph similar to the following should be added after the opinion paragraph:

In accordance with *Government Auditing Standards*, we have also issued a report dated [date of report] on our consideration of City of Example's internal control structure and a report dated [date of report] on its compliance with laws and regulations.

**Example A.2**

**Unqualified Opinion on General-Purpose Financial Statements  
Submitted Together With Combining, Individual Fund, and Account  
Group Financial Statements and Supporting Schedules as  
Supplementary Data**

Independent Auditor's Report

We have audited the accompanying general-purpose<sup>4</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>5</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>6</sup>

Our audit was made for the purpose of forming an opinion on the general-purpose financial statements taken as a whole. The combining and individual fund and account group financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the general-purpose financial statements of City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly presented in all material respects in relation to the general-purpose financial statements taken as a whole.<sup>7</sup>

[Signature]

[Date]

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<sup>4</sup> See footnote 1.

<sup>5</sup> See footnote 2.

<sup>6</sup> See footnote 3.

<sup>7</sup> When reporting on supplementary data, the auditor should consider the effect of any modifications in the report on the general-purpose financial statements on the supplementary data. Guidance on reporting in such circumstances is provided in SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551) and SAS No. 42 (AICPA, *Professional Standards*, vol. 1, AU sec. 552).

**Example A.3****Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements, Presented Together With Supporting Schedules Reported on as Supplementary Data****Independent Auditor's Report**

We have audited the accompanying general-purpose<sup>8</sup> financial statements and the combining and individual fund and account group financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>9</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining and individual fund and account group financial statements referred to above present fairly, in all material respects, the financial position of each of the individual funds and account groups of City of Example, Any State, as of June 30, 19X1, and the results of operations of such funds and the cash flows of individual proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>10</sup>

Our audit was made for the purpose of forming an opinion on the general-purpose financial statements taken as a whole and on the combining and individual fund and account group financial statements. The accompanying financial information listed as supporting schedules in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements of City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose, combining and individual fund and account group financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements of each of the respective individual funds and account groups taken as a whole.<sup>11</sup>

[Signature]

[Date]

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<sup>8</sup> See footnote 1.

<sup>9</sup> See footnote 2.

<sup>10</sup> See footnote 3.

<sup>11</sup> See footnote 7.



**Example A.4****Report on Primary Government Financial Statements That Omit the  
Financial Data of Each Component Unit**Independent Auditor's Report

We have audited the accompanying primary government financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>12</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

A primary government is a legal entity or body politic and includes all funds, organizations, institutions, agencies, departments, and offices that are not legally separate. Such legally separate entities are referred to as component units. In our opinion, the primary government financial statements present fairly, in all material respects, the financial position of the primary government of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

However, the primary government financial statements, because they do not include the financial data of component units of City of Example, Any State, do not purport to, and do not, present fairly the financial position of the City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>13</sup>

[Signature]

[Date]

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<sup>12</sup> See footnote 2.

<sup>13</sup> See footnote 3.

## Example A.5

**Qualified Opinion on General-Purpose Financial Statements That  
Omit One or More, But Not All, Component Units of the Financial  
Reporting Entity<sup>14</sup>**

Independent Auditor's Report

We have audited the accompanying general-purpose<sup>15</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>16</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include financial data of the *[identify the component unit(s) omitted]*, which should be included in order to conform with generally accepted accounting principles. If the omitted component unit(s) had been included,<sup>17</sup> the assets and revenues of the *[identify fund type(s)—for example, special revenue fund type—or component unit column(s)]* would have been increased by \$XXX,XXX and \$XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type *[or component unit(s)]* of \$XXX,XXX for the year, and the *[identify fund type(s) or discretely presented component unit column]* fund balance would have been a deficit of \$XXX,XXX.

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<sup>14</sup> There may be circumstances when, based on professional judgment, the auditor may determine that an adverse opinion on the general-purpose financial statements is appropriate. In such a case, a separate explanatory paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters. If an adverse opinion is to be rendered, the last two paragraphs of this report should be replaced with the following paragraphs:

The general-purpose financial statements referred to above do not include financial data of the *[identify the component unit(s) omitted]*, which should be included in order to conform with generally accepted accounting principles.

Because of the departure from generally accepted accounting principles identified above, as of June 30, 19X1, the assets and revenues of the *[identify fund type(s)—for example, special revenue fund type—or component unit column(s)]* would have increased by \$XXX,XXX and \$XXX,XXX, respectively, there would have been an excess of expenditures over revenues in the fund type *[or component unit(s)]* for the year of \$XXX,XXX and the *[identify fund type(s) or component unit(s)]* fund balance would have been a deficit of \$XXX,XXX.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the general-purpose financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of City of Example, Any State, as of June 30, 19X1, or the results of its operations or the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended.

<sup>15</sup> See footnote 1.

<sup>16</sup> See footnote 2.

<sup>17</sup> If the amounts applicable to the omitted component unit have not been audited, insert the phrase *based on unaudited information*.

In our opinion, except for the effects on the financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>18</sup>

[Signature]

[Date]

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<sup>18</sup> See footnote 3.

**Example A.6****Qualified Opinion on General-Purpose Financial Statements That  
Omit a Fund Type or Account Group<sup>19</sup>****Independent Auditor's Report**

We have audited the accompanying general-purpose<sup>20</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>21</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include the *[identify the fund type (account group) omitted]*, which should be included in order to conform with generally accepted accounting principles. The omitted fund type<sup>22</sup> has assets, liabilities, revenues, and expenditures of \$XXX,XXX, \$XXX,XXX, \$XXX,XXX, and \$XXX,XXX, respectively. *[The amount that should be recorded in the (identify account group) is not known.]*

In our opinion, except for the effect on the financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>23</sup>

*[Signature]*

*[Date]*

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<sup>19</sup> See footnote 14.

<sup>20</sup> See footnote 1.

<sup>21</sup> See footnote 2.

<sup>22</sup> If the amounts applicable to the omitted fund type or account group have not been audited, insert the phrase *based on unaudited information*.

<sup>23</sup> See footnote 3.

Example A.7

Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type<sup>24</sup>

Independent Auditor's Report

We have audited the accompanying general-purpose<sup>25</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>26</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include the *[identify the omitted fund]*, which should be included in order to conform with generally accepted accounting principles. If the omitted fund<sup>27</sup> had been included, the *[identify fund type]* assets, liabilities, revenues, and expenditures would have increased \$XXX,XXX, \$XXX,XXX, \$XXX,XXX, and \$XXX,XXX, respectively.

In our opinion, except for the effect on the general-purpose financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>28</sup>

[Signature]  
[Date]

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<sup>24</sup> See footnote 14.

<sup>25</sup> See footnote 1.

<sup>26</sup> See footnote 2.

<sup>27</sup> If the amounts applicable to the omitted fund have not been audited, insert the phrase *based on unaudited information*.

<sup>28</sup> See footnote 3.

**Example A.8****Unqualified Opinion on General Fund Financial Statements With an  
Explanatory Paragraph Calling Attention to the Fact That the  
Financial Statements Do Not Represent the Financial Position and  
Results of Operations of the Financial Reporting Entity****Independent Auditor's Report**

We have audited the accompanying financial statements of the general fund of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>29</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements present only the general fund and are not intended to present fairly the financial position and results of operations of City of Example, Any State, in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the general fund of City of Example, Any State, as of June 30, 19X1, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.<sup>30</sup>

[Signature]

[Date]

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<sup>29</sup> See footnote 2.

<sup>30</sup> See footnote 3.

**Example A.9**

**Unqualified Opinion on an Enterprise Fund's Financial Statements  
With an Explanatory Paragraph Calling Attention to the Fact That  
the Financial Statements Do Not Represent the Financial Position and  
Results of Operations of the Financial Reporting Entity**

Independent Auditor's Report

We have audited the accompanying financial statements of [*identify enterprise fund*] of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>31</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements present only the [*identify enterprise fund*] and are not intended to present fairly the financial position of City of Example, Any State, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*identify enterprise fund*] of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows for the year then ended in conformity with generally accepted accounting principles.<sup>32</sup>

[Signature]

[Date]

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<sup>31</sup> See footnote 2.

<sup>32</sup> See footnote 3.

**Example A.10**

**Unqualified Opinion on General-Purpose Financial Statements  
With an Explanatory Paragraph Calling Attention to a Financial  
Reporting Entity's Ability to Meet its Debts as They Come Due<sup>[33-36]</sup>**

[Deleted as a result of the issuance of SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements (AICPA *Professional Standards*, vol. 1, AU sec. 508).]

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<sup>[33-36]</sup> [Deleted.]



Example A.11

**Qualified Opinion on General-Purpose Financial Statements That Include  
an Unaudited Organization, Function, or Activity**

Independent Auditor's Report

We have audited the accompanying general-purpose<sup>37</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards.<sup>38</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain the audited financial statements supporting the financial activities of the *[identify the organization, function, or activity]*, nor were we able to satisfy ourselves as to those financial activities by other auditing procedures. Those financial activities are included in the *[identify fund type, account group, or component unit column(s)]* and represent XX percent and XX percent of the assets and revenues, respectively, of *[identify fund type, account group, or component unit column]*.

In our opinion, except for the effects of such adjustment, if any, as might have been determined to be necessary had we been able to obtain the audited financial statements of *[identify the organization, function, or activity]*, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>39</sup>

[Signature]

[Date]

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<sup>37</sup> See footnote 1.

<sup>38</sup> See footnote 2.

<sup>39</sup> See footnote 3.

**Example A.12(A)****Unqualified Opinion on General-Purpose Financial Statements With  
Reference to an Audit of an Organization, Function, or Activity by  
Other Auditors**Independent Auditor's Report

We have audited the accompanying general-purpose<sup>40</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit. We did not audit the financial statements of *[identify organization, function, or activity]*, which represent XX percent and XX percent, respectively, of the assets and revenues of the *[identify fund type, account group, or component unit column(s)]*. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for *[identify organization, function, or activity]*, is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.<sup>41</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>42</sup>

[Signature]

[Date]

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<sup>40</sup> See footnote 1.

<sup>41</sup> See footnote 2.

<sup>42</sup> See footnote 3.

**Example A.12(B)**

**Unqualified Opinion on General-Purpose Financial Statements and  
Combining, Individual Fund, and Account Group Financial Statements  
When One Fund or Component Unit Representing Less Than All of a  
Fund Type Has Been Audited by Other Auditors**

Independent Auditor's Report

We have audited the accompanying general-purpose<sup>43</sup> financial statements and the combining and individual fund and account group financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of the *[identify fund or component unit]* which statements reflect total assets of \$XXX,XXX as of June 30, 19X1, and total revenues of \$XXX,XXX for the year then ended. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion on the financial statements, insofar as it relates to the amounts included for the *[identify fund or component unit]* in the *[identify fund type or component unit column(s)]*, is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.<sup>44</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining, individual fund, and account group financial statements referred to above (other than the *[identify fund or component unit]*, whose financial statements were audited by other auditors whose report expressed an unqualified opinion) present fairly, in all material respects, the financial position of each of the individual funds and account groups of City of Example, Any State, at June 30, 19X1, and the results of operations of such funds and the cash flows of individual proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>45</sup>

*[Signature]*

*[Date]*

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<sup>43</sup> See footnote 1.

<sup>44</sup> See footnote 2.

<sup>45</sup> See footnote 3.

**Example A.13****Unqualified Opinion on General-Purpose Financial Statements With  
Reference to an Audit of *All* of a Fund Type by Other Auditors**Independent Auditor's Report

We have audited the accompanying general-purpose<sup>46</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit. We did not audit the financial statements of the *[identify fund type]*. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion on the general-purpose financial statements, insofar as it relates to the amounts included for the *[identify fund type]*, is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.<sup>47</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>48</sup>

[Signature]

[Date]

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<sup>46</sup> See footnote 1.

<sup>47</sup> See footnote 2.

<sup>48</sup> See footnote 3.

**Example A.14****Unqualified Opinion on Financial Statements Prepared in Accordance  
With a Comprehensive Basis of Accounting Other Than Generally  
Accepted Accounting Principles****Independent Auditor's Report**

We have audited the accompanying financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>49</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, City of Example, Any State, prepares its financial statements on the cash basis, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the cash and unencumbered cash balances of City of Example, Any State, as of June 30, 19X1, and the revenues it received and expenditures it paid for the year then ended on the basis of accounting described in Note X.<sup>50, 51</sup>

[Signature]

[Date]

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<sup>49</sup> See footnote 2.

<sup>50</sup> If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject, the opinion paragraph should be followed by a paragraph that restricts the distribution of the report solely to those within the entity and for filing with the regulatory agency. See paragraphs 5f and 8 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.05f and .08).

<sup>51</sup> See footnote 3.

**Example A.15****Unqualified Opinion on Financial Statements of a Department  
Constituting Less Than a Fund****Independent Auditor's Report**

We have audited the accompanying financial statements of Department of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of Department of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>52</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements of the Department of Example, Any State, are intended to present the financial position and results of operations and the cash flows of proprietary fund types of only that portion of the financial reporting entity of the State that is attributable to the transactions of the Department.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Department of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows for the year then ended in conformity with generally accepted accounting principles.<sup>53</sup>

[Signature]

[Date]

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<sup>52</sup> See footnote 2.

<sup>53</sup> See footnote 3.

**Example A.16****Unqualified Opinion on Supplementary Schedule of Federal Financial Assistance**

We have audited the general-purpose<sup>54</sup> financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>55</sup> These general-purpose financial statements are the responsibility of City of Example, Any State's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Our audit was made for the purpose of forming an opinion on the general-purpose financial statements of City of Example, Any State, taken as a whole. The accompanying Schedule of Federal Financial Assistance is presented for purposes of additional analysis and is not a required part of the general-purpose financial statements. The information in that schedule has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly presented in all material respects in relation to the general-purpose financial statements taken as a whole.<sup>56</sup>

[Signature]

[Date]

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<sup>54</sup> See footnote 1.

<sup>55</sup> Describe any departure from the standard report.

<sup>56</sup> See footnote 7.

**Example A.17(A)****Unqualified Report on Compliance Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards*—No Reportable Instances of Noncompliance**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>57</sup>

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to City of Example, Any State, is the responsibility of City of Example, Any State's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of City of Example, Any State's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the general-purpose financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.<sup>58, 59</sup>

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

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<sup>57</sup> See footnote 55.

<sup>58</sup> See *Government Auditing Standards*, chapter 5, paragraphs 5.18 and 5.19, for reporting criteria.

<sup>59</sup> If the auditor has issued a separate letter to communicate irregularities, illegal acts or other noncompliance that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following:

We noted certain immaterial instances of noncompliance that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1.



**Example A.17(B)**

**Qualified Report on Compliance Based on an Audit of General-Purpose  
Financial Statements Performed in Accordance With *Government Auditing  
Standards*—Reportable Instances of Noncompliance**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>60</sup>

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to City of Example, Any State, is the responsibility of the City of Example, Any State's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of City of Example, Any State's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the general-purpose financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed the following instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.<sup>61, 62</sup>

*[Include paragraphs describing the instances of noncompliance noted.]*

We considered these instances of noncompliance in forming our opinion on whether City of Example, Any State's 19X1 general-purpose financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19X1, on those general-purpose financial statements.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record and its distribution is not limited.

*[Signature]*

*[Date]*

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<sup>60</sup> See footnote 55.

<sup>61</sup> See footnotes 58 and 59.

<sup>62</sup> The auditor should consider whether the instances of noncompliance warrant disclosure in the general-purpose financial statements or provide a basis for recording a loss contingency. If instances of noncompliance are material, either individually or in the aggregate, the auditor should also consider the effect of the noncompliance on the report on the general-purpose financial statements in accordance with SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508).

**Example A.18(A)****Single Audit Unqualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>63</sup>

We have also audited City of Example, Any State's compliance with the requirements governing [*list specific requirements tested—see chapter 23, paragraph 23.40 of this guide*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,<sup>64</sup> for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.<sup>65</sup>

In our opinion, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

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<sup>63</sup> See footnote 55.

<sup>64</sup> Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

<sup>65</sup> When there are no instances of noncompliance, this paragraph should be deleted.

**Example A.18(B)****Single Audit Qualified Opinion on Compliance With Specific  
Requirements Applicable to Major Federal Financial Assistance  
Programs—Uncertainties<sup>[66–68]</sup>**

[Deleted as a result of the issuance of SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements (AICPA Professional Standards, vol. 1, AU sec. 508).]

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<sup>[66–68]</sup> [Deleted.]

**Example A.19****Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>69</sup>

We have also audited the compliance of City of Example, Any State, with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,<sup>70</sup> for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting compliance of City of Example, Any State, with the requirements of Major Program ABC governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to City of Example, Any State's compliance with those requirements of Major Program ABC by other auditing procedures.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding City of Example, Any State's compliance with the requirements of Major Program ABC governing types of services allowed or unallowed, City of Example, Any State, complied, in all material respects, with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

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<sup>69</sup> See footnote 55.

<sup>70</sup> See footnote 64.

**Example A.20****Single Audit Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>71</sup>

We were also engaged to audit the compliance of City of Example, Any State, with the requirements governing [*list requirements to have been tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,<sup>72</sup> for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements.

The management of City of Example, Any State, has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on City of Example, Any State's compliance with the requirements governing [*list requirements to have been tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

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<sup>71</sup> See footnote 55.

<sup>72</sup> See footnote 64.

**Example A.21****Single Audit Qualified Opinion on Compliance With Specific Requirements  
Applicable to Major Federal Financial Assistance  
Programs—Noncompliance**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>73</sup>

We have also audited the compliance of City of Example, Any State, with the requirements governing *[list requirements tested]* that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,<sup>74</sup> for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

As further described in the accompanying Schedule of Findings and Questioned Costs, the results of our audit procedures for *[name]* program disclosed that City of Example, Any State, did not comply with the requirement that *[identify the requirement]*. In our opinion, City of Example, Any State's compliance with this requirement is necessary for City of Example, Any State, to comply with the requirements applicable to the *[name]* program.<sup>74a</sup>

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to in the third paragraph, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for those instances of noncompliance with the requirements applicable to Major Program ABC referred to in the fourth paragraph of this report, City of Example, Any State, complied, in all material respects, with the requirements governing *[list requirements tested]* that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

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<sup>73</sup> See footnote 55.

<sup>74</sup> See footnote 64.

<sup>74a</sup> If the effect of the noncompliance cannot be reasonably estimated and the ultimate resolution is not known, the auditor should explain this in the Schedule of Findings and Questioned Costs as part of the description of the noncompliance. (An example of an instance of noncompliance that cannot be reasonably estimated is noncompliance with a U.S. Department of Education program that requires that the number of children in the program to equal at least 400, or 3 percent of the total number of children in average daily attendance.)

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record and its distribution is not limited.

*[Signature]*

*[Date]*

**Example A.22****Single Audit Adverse Opinion on Compliance With Specific Requirements  
Applicable to Major Federal Financial Assistance Programs**

We have audited the financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>75</sup>

We have also audited the compliance of City of Example, Any State, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,<sup>76</sup> for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

[*Add a paragraph describing reasons for the adverse opinion.*]

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, because of those instances of noncompliance referred to in the fourth paragraph, City of Example, Any State, did not comply, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

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<sup>75</sup> See footnote 55.

<sup>76</sup> See footnote 64.



**Example A.23(A)****Single Audit Unqualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>77</sup>

We have applied procedures to test City of Example, Any State's compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the Schedule of Federal Financial Assistance, for the year ended June 30, 19X1 [*list the general requirements tested*].

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.<sup>78</sup>

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

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<sup>77</sup> See footnote 55.

<sup>78</sup> When there are no immaterial instances of noncompliance, this sentence should be deleted.

## Example A.23(B)

**Single Audit Qualified Report on Compliance With the General  
Requirements Applicable to Federal Financial Assistance Programs—  
Material Noncompliance<sup>79</sup>**

We have audited the general-purpose financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>80</sup>

We have applied procedures to test City of Example, Any State's compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the Schedule of Federal Financial Assistance, for the year ended June 30, 19X1 [list general requirements tested].

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments* [or describe alternative procedures performed]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

Material instances of noncompliance consist of failures to follow the general requirements that caused us to conclude that the misstatements resulting from those failures are material [indicate program(s) or financial statements]. The results of our tests of compliance disclosed material instances of noncompliance that are described in the accompanying Schedule of Findings and Questioned Costs.<sup>81</sup>

We considered these material instances of noncompliance in forming our opinion on whether City of Example, Any State's 19X1 general-purpose financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19X1, on those financial statements.<sup>82</sup>

Except as described above, the results of our procedures to determine compliance indicate that, with respect to the items tested, City of Example, Any State, complied, in all material respects, with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not

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<sup>79</sup> See chapter 23, paragraph 23.81, which discusses materiality with respect to the general requirements.

<sup>80</sup> See footnote 55.

<sup>81</sup> If, individually or collectively, the instances of noncompliance are also material to the general-purpose financial statements, the report on compliance required by *Government Auditing Standards* is modified. See example A.17(B).

<sup>82</sup> The following is an illustration of the auditor's report when the auditor determines noncompliance is pervasive and the auditor is not able to provide negative assurance on general requirements.

[First three paragraphs and last paragraph are the same as in the report illustrated above.]

With respect to the items tested, City of Example, Any State, complied with the requirements listed in the second paragraph, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that City of Example, Any State, may not have complied with the requirements referred to in the second paragraph. These matters were considered by us in evaluating whether the general-purpose financial statements are presented fairly in conformity with generally accepted accounting principles.

complied, in all material respects, with those requirements. However, the results of our procedures also disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.<sup>83</sup>

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

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<sup>83</sup> When there are no immaterial instances of noncompliance noted, this sentence should be deleted.

## Example A.23(C)

**Single Audit Qualified Report on Compliance With the General  
Requirements Applicable to Federal Financial Assistance Programs—  
Scope Limitation<sup>84</sup>**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>85</sup>

We have applied procedures to test City of Example, Any State's compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the Schedule of Federal Financial Assistance, for the year ended June 30, 19X1 [*list general requirements tested*].

Except as described in the following paragraph, our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments* [or describe alternative procedures performed]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

We were unable to obtain sufficient documentation of City of Example, Any State's compliance with the cash management and relocation assistance and real property acquisition requirements of Program ABC, nor were we able to satisfy ourselves by alternative procedures as to City of Example, Any State's compliance with those requirements of Program ABC.

With respect to the items tested, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding City of Example, Any State's compliance with the cash management and relocation assistance and real property acquisition requirements of Program ABC, City of Example, Any State, complied, in all material respects, with the requirements listed in the first paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements. The results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.<sup>86</sup>

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

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<sup>84</sup> See chapter 23, paragraph 23.81, which discusses materiality with respect to the general requirements.

<sup>85</sup> See footnote 55.

<sup>86</sup> If there is pervasive noncompliance and negative assurance cannot be provided, the standard report should be modified as shown in footnote 82.

## Example A.24

**Single Audit Unqualified Report on Compliance With Specific  
Requirements Applicable to Nonmajor Federal Financial Assistance  
Program Transactions<sup>87</sup>**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>88</sup>

In connection with our audit of the general-purpose financial statements of City of Example, Any State, and with our consideration of City of Example, Any State's control structure used to administer federal financial assistance programs, as required by Office of Management and Budget Circular A-128, *Audits of State and Local Governments*, we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 19X1. As required by OMB Circular A-128, we have performed auditing procedures to test compliance with the requirements governing [*list requirements tested*] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements.<sup>89</sup> However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.<sup>90</sup>

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

<sup>87</sup> See example A.23(B) for modification when material noncompliance is detected.

<sup>88</sup> See footnote 55.

<sup>89</sup> The following is an illustration of the auditor's report when the auditor determines noncompliance for nonmajor program transactions is pervasive and the auditor is not able to provide negative assurance.

[First two paragraphs and last paragraph are the same as in the report illustrated above.]

The results of our tests indicate that, with respect to the items tested, City of Example, Any State, complied with those requirements, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to nonmajor program transactions not tested by us, there is more than a relatively low risk that City of Example, Any State, may not have complied with the requirements referred to in the preceding paragraph. These matters were considered by us in evaluating whether the general-purpose financial statements are presented fairly in conformity with generally accepted accounting principles.

<sup>90</sup> If there are no instances of noncompliance, this sentence should be deleted.

**Example A.25(A)**

**Report on the Internal Control Structure Based on an Audit of  
General-Purpose Financial Statements Performed in Accordance With  
Government Auditing Standards**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>91</sup>

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles.<sup>92</sup> Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the general-purpose financial statements of City of Example, Any State, for the year ended June 30, 19X1, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the general-purpose financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the general-purpose financial statements.

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<sup>91</sup> See footnote 55.

<sup>92</sup> If the financial statements are on a basis other than GAAP (for example, cash basis, or in accordance with the U.S. Department of Housing and Urban Development [HUD] Accounting Manual), the phrase "generally accepted accounting principles" should be modified.

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the general-purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.<sup>93</sup>

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19X1.<sup>94</sup>

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record, and its distribution is not limited.

*[Signature]*

*[Date]*

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<sup>93</sup> If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be modified as follows:

However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of City of Example, Any State for the year ended June 30, 19X1.

*[A description of the material weaknesses that have come to the auditor's attention would follow.]*

<sup>94</sup> If a separate letter has not been issued, this paragraph should be omitted.

**Example A.25(B)**

**Report on the Internal Control Structure Based on an Audit of  
General-Purpose or Basic Financial Statements Performed in Accordance  
With *Government Auditing Standards*—No Material Weaknesses When  
There Are No Reportable Conditions**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>95</sup>

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles.<sup>96</sup> Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the general-purpose financial statements of City of Example, Any State, for the year ended June 30, 19X1, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the general-purpose financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that

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<sup>95</sup> See footnote 55.

<sup>96</sup> See footnote 92.



would be material in relation to the general-purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19X1.<sup>97</sup>

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

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<sup>97</sup> If a separate letter has not been issued, this paragraph should be omitted.

**Example A.26(A)****Single Audit Report on the Internal Control Structure Used in  
Administering Federal Financial Assistance Programs**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>98</sup> We have also audited the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs and have issued our report thereon dated August 15, 19X1.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19X1, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinions on the general-purpose financial statements of City of Example, Any State, and on the compliance of City of Example, Any State, with requirements applicable to major programs, and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19X1.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles<sup>99</sup> and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assis-

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<sup>98</sup> See footnote 55.

<sup>99</sup> See footnote 92.

tance programs in the following categories: [*identify internal control structure categories*].<sup>100</sup>

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<sup>100</sup> Following are examples of different ways in which internal control structure policies and procedures used in administering federal financial assistance programs might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which the auditor is reporting. However, there is no need to present detailed internal control structure policies and procedures, even though test work may be performed at that level.

Activity Cycles

- Treasury or financing
- Revenue/receipts
- Purchases/disbursements
- External financial reporting
- Payroll/personnel

Financial Statement Captions

- Cash and cash equivalents
- Receivables
- Inventory
- Property and equipment
- Payables and accrued liabilities
- Debt
- Fund balance

Accounting Applications

- Billings
- Receivables
- Cash receipts
- Purchasing and receiving
- Accounts disbursements
- Payroll
- Inventory control
- Property and equipment
- General ledger

General Requirements

- Political activity
- Davis-Bacon Act
- Civil rights
- Cash management
- Relocation assistance and real property management
- Federal financial reports

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.<sup>101</sup>

During the year ended June 30, 19X1, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

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*(Footnote Continued)*

- Allowable costs/cost principles
- Drug-free workplace
- Administrative requirements
- Specific Requirements
- Types of Services
- Eligibility
- Matching, level of effort, or earmarking
- Reporting
- Cost allocation
- Special requirements, if any
- Monitoring subrecipients
- Claims for Advances and Reimbursements
- Amounts Claimed or Used for Matching

<sup>101</sup> If a cyclical approach is used (see chapter 23, paragraph 23.23), this paragraph should be modified, and a paragraph that clearly describes the coverage provided for nonmajor programs should be added after it as follows:

Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs on a cyclical basis. Our procedures during the current year covered X percent of the nonmajor programs administered by City of Example, Any State, as a whole. The nonmajor programs not covered during the current year have been or are expected to be subject to such procedures at least once during the X year cycle.

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.<sup>102</sup>

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19X1.<sup>103</sup>

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record, and its distribution is not limited.

*[Signature]*

*[Date]*

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<sup>102</sup> If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the audit of compliance with requirements applicable to major federal financial assistance programs. The last sentence of this paragraph should be modified as follows:

However, we noted the follow in matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the compliance of City of Example, Any State, with requirements applicable to its major federal financial assistance programs for the year ended June 30, 19X1, and this report does not affect our report thereon dated August 15, 19X1.

*[A description of the material weaknesses that have come to the auditor's attention would follow.]*

<sup>103</sup> See footnote 97.

**Example A.26(B)**

**Single Audit Report on the Internal Control Structure Used in  
Administering Federal Financial Assistance Programs—No Material  
Weaknesses When There Are No Reportable Conditions<sup>104</sup>**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. We have also audited the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs and have issued our report thereon dated August 15, 19X1.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19X1, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinions on the general-purpose financial statements of City of Example, Any State, and on the compliance of City of Example, Any State, with requirements applicable to major programs, and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19X1.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles, and federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the

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<sup>104</sup> See footnotes to example A.26(A).

risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs into the following categories.

*[Identify internal control structure categories.]*

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19X1, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the major federal financial assistance programs of City of Example, Any State, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19X1.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record and its distribution is not limited.

*[Signature]*

*[Date]*

**Example A.26(C)****Single Audit Report on the Internal Control Structure Used in  
Administering Federal Financial Assistance Programs—No Tests of  
Controls Are Performed for Certain Compliance Requirements<sup>105</sup>**

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. We have also audited the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs and have issued our report thereon dated August 15, 19X1.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19X1, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinions on the general-purpose financial statements of City of Example, Any State, and on the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs, and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19X1.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods

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<sup>105</sup> See footnotes to example A.26(A).



is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures into the following categories: *[identify internal control structure categories]*.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19X1, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

Except as discussed in the following paragraph, we performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

For *[identify relevant federal financial assistance programs]*, we performed no tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that could be relevant to preventing or detecting material noncompliance with *[identify relevant compliance requirements]*. We did not perform such tests because the results of procedures we performed to obtain an understanding of the design of internal control structure policies and procedures and whether they have been placed in operation indicated that *[describe the absence of relevant policies and procedures or the circumstances that cause the auditor to conclude that policies and procedures are unlikely to be effective]*. We consider this condition to be a reportable condition under standards established by the American Institute of Certified Public Accountants.

Reportable conditions involve matters coming to our attention concerning significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations. In addition to the reportable conditions identified in the preceding paragraph, we noted other matters involving the internal control structure and its operation that we consider to be reportable conditions.

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19X1.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record, and its distribution is not limited.

*[Signature]*

*[Date]*

**Example A.26(D)****Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—Total Assistance Expended Under Major Programs Is Less Than 50 Percent of Federal Financial Assistance<sup>106</sup>**

If total assistance expended under major federal financial assistance programs is less than 50 percent of total federal assistance expended by the recipient organization during the year under audit, the auditor should follow the guidance in paragraph 23.09 to satisfy the objectives of the Single Audit Act. When such guidance is followed, the first six paragraphs of the report on the internal control structure used to administer federal financial assistance programs are the same as in example A.26(A); the seventh and eighth paragraphs should be modified as follows:

During the year ended June 30, 19X1, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs and the following nonmajor federal financial assistance programs: *[list appropriate nonmajor federal financial assistance programs]*.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance, and the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

The final paragraphs are the same as in example A.26(A).

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<sup>106</sup> See footnotes to example A.26(A).

**Example A.26(E)****Single Audit Report on the Internal Control Structure Used  
in Administering Federal Financial Assistance  
Programs—No Major Programs<sup>107</sup>**

If the recipient organization had no major federal financial assistance programs during the year under audit, the auditor should follow the guidance in paragraph 23.21 to satisfy the objectives of the Single Audit Act. When such guidance is followed, the auditor's report on the internal control structure in example A.26(A) should be modified as follows:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement.

In planning and performing our audit for the year ended June 30, 19X1, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinion on City of Example, Any State's general-purpose financial statements and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19X1.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

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<sup>107</sup> See footnotes to example A.26(A).

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs into the following categories: *[identify internal control structure categories]*.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19X1, City of Example, Any State, had no major federal financial assistance programs and expended X percent of its total federal financial assistance under the following nonmajor federal financial assistance programs: *[list appropriate nonmajor federal financial assistance programs]*.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we have considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

The final paragraphs are the same as in example A.26(A).

**Example A.27****Report on Separately Issued Summary Financial Information Prepared  
in Accordance With the Guidance Provided in Paragraph 18.23****Independent Auditor's Report**

We have audited, in accordance with generally accepted auditing standards, the general-purpose financial statements of [*City of Example*] as of and for the year ended June 30, 19XX (not presented herein), and have issued our report thereon dated August 15, 19XX.<sup>108</sup>

As explained in Note [x], the accompanying summary financial information of [*City of Example*], as of and for the year ended June 30, 19XX, is not a presentation in conformity with generally accepted accounting principles. In our opinion, however, the accompanying summary financial information is fairly stated, in all material respects, in relation to the general-purpose financial statements from which it has been derived.

[Signature]

[Date]

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<sup>108</sup> Describe any departure from the standard report.

**Example A.28****Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23**Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the general-purpose financial statements of [*City of Example*] as of and for the year ended June 30, 19XX (not presented herein), and have issued our report thereon dated August 15, 19XX.<sup>109</sup>

As explained in Note [x], the accompanying summary financial information of [*City of Example*], as of and for the year ended June 30, 19XX, is not a presentation in conformity with generally accepted accounting principles. Furthermore, the summary financial information has been prepared [*specify reason(s) for adverse report, for example, using a different measurement focus and basis of accounting*]<sup>110</sup> from the general-purpose financial statements].

In our opinion, because of the significance of [*specify reason(s) for adverse report, for example, using a different measurement focus and basis of accounting*], the accompanying summary financial information, as of and for the year ended June 30, 19XX, is not fairly stated in relation to the general-purpose financial statements.

[Signature]

[Date]

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<sup>109</sup> Describe any departure from the standard report

<sup>110</sup> A different measurement focus and basis of accounting would include changing from a modified accrual basis of accounting to a cash basis, recording depreciation on general fixed assets through the operating statement of a governmental fund type, etc.

## Appendix B<sup>\*</sup>

### ***Illustrative Internal Control Structure Questions—State and Local Governmental Units***

.010 The following is a list of illustrative internal control structure questions an auditor might raise concerning a state or local governmental unit. The extent of internal control structure policies and procedures that an organization should establish is a judgment that must be made by the management of the entity. The judgment is affected by circumstances, such as the size of the organization and the number of personnel available, and by conclusions about the relationship of costs and benefits. These illustrative questions are numbered merely for organization purposes. The numbers are in no way intended to infer completeness or a preferred sequence. A firm that believes the questionnaire approach is appropriate for its practice should develop its own internal control structure questionnaires based on its own needs and preferences. In any event, users of checklists and questionnaires should recognize that important matters in a particular set of circumstances may not be covered in a standard checklist. In December 1995, SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, was issued which revises the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. Since SAS No. 78 is not effective for audits of financial statements until periods beginning on or after January 1, 1997 (early application is permitted), these illustrative questions have not been updated to include the new requirements.

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<sup>\*</sup> Reprinted from *AICPA Audit and Accounting Manual (AAM)*, section 12.010. New York: American Institute of Certified Public Accountants.



I. Control Environment\*

.020 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- Personnel policies and practices
- Methods of assigning authority and responsibility
- Management's control methods for monitoring and following-up on performance, including internal auditing and budgeting
- Various external influences that affect an entity's operations and practices

.030 The control environment reflects the overall attitude, awareness, and actions of the legislative, management, staff, and others concerning the importance of the control and its emphasis in the entity.

.040 The following questions are to assist the auditor in obtaining an understanding of the control environment and assessing the control risk.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<b>.050 A. Management's Philosophy and Operating Style</b>							
1. Does management often enter into particularly high-risk ventures, or is extremely conservative in accepting risks?	—	—	—		—		
2. Does management conduct business on a high ethical plane and insist that others do so, or pay little attention to ethical issues?		—			—		
3. Does management have to meet rigid targets to receive a portion of their compensation (e.g., bonus), particularly when such targets are considered unreasonably difficult?		—		—	—		

\* The control environment questions in AAM section 12,010.020-.100 specifically apply to governmental entities and are not intended to be all inclusive. The auditor should also consider the illustrative control environment inquiries in AAM section 4400.14, which may apply to governmental entities.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
4. What is management's attitude and actions toward financial reporting, including disputes over application of accounting treatment (e.g., selection of conservative versus liberal accounting policies; whether accounting principles have been misapplied, important financial information not disclosed, or records manipulated or falsified)?					—		
5. Is management conscientious and applies integrity with the judgmental aspects of reporting, when developing estimates?				—	—		
6. Is there frequent interacting between senior management and operating management, particularly for geographically removed units?	—	—					
7. What is management's attitude toward the data processing and accounting functions, and their concerns about the reliability of financial reporting and safeguarding assets?	—				—		
8. Has management communicated a commitment to a strong internal control structure to employees during the past year?	—	—			—		
9. Does management periodically review the internal control structure to ensure that it is being enforced?	—	—					
10. What is management's attitude towards overriding or bypassing established controls?	—	—					
11. Has management conveyed the message that ethics cannot be compromised and have employees received and understood that message?	—						
12. Does the "tone at the top" include explicit moral guidance about what is right and what is wrong, and is it established and communicated throughout the organization?	—				—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Complete- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<b>.060 B. Organizational Structure</b>							
1. Is the organizational structure so simple that it cannot adequately monitor the organization's activities, or so complex that it inhibits the necessary flow of information?	—	—					
2. Does management fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions?	—						
3. Is there an adequate definition of key managers' responsibilities and an appropriate understanding of those responsibilities?	—	—					
4. Do key managers possess the appropriate knowledge and experience in light of their responsibilities?	—	—					
5. Is the entity's organizational structure appropriate so as to provide the necessary information flow to manage its activities?	—	—					
6. Are the reporting relationships appropriate?	—	—					
7. To what extent are organizational modifications made in light of changing conditions?	—	—					
8. Are there sufficient quantities of employees, particularly in management and supervisory capacities?	—	—					
9. Is the organization chart current?	—	—					
10. Is the organization properly synchronized for the program/budget structure?	—	—			—		
11. Are goals and objectives for the organization current and in writing?	—	—					
12. Are functional statements current and in writing and consistent with organization chart?	—	—					
<b>.070 C. Personnel Policies and Procedures</b>							
1. Do personnel practices include:							

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
a. A code of conduct?	—						
b. Provisions for conflict of interest disclosure?	—						
2. Are there accurate and up-to-date performance standards?	—	—					
3. Are the performance standards consistent with the operating plan?	—	—					
4. Is there periodic performance review (appraisal) of all employees?	—						
5. Are there sufficient training opportunities to ensure all employees are competent to perform work assigned?	—	—					
6. To what extent are policies and procedures for hiring, training, promoting, and compensating employees in place?	—	—					
7. To what extent are employees made aware of their responsibilities and expectations of them?	—	—					
8. Is there appropriate remedial action taken in response to departures from approved policies and procedures and violations of the code of conduct?	—						
9. Are there adequate employee candidate background checks, particularly with regard to prior actions or activities considered to be unacceptable by the entity?	—						
10. Are there adequate employee retention and promotion criteria and related information gathering techniques related to compliance with the code of conduct or other behavioral guidelines?	—						
11. Do management performance standards include provisions for maintaining adequate internal controls?	—						
12. Are employees adequately supervised?	—	—					
13. Are staffing levels adequate?	—	—					
14. Is turnover low?	—	—					
15. Do employees have copies of their current position description?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Complete- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
16. Is orientation training conducted for new employees?	—						
17. Are employees aware of their rights to communicate with any official of rank higher than their immediate supervisor?	—	—			—		
<b>.080 D. Authority and Responsibility</b>							
1. Are delegations of authority and responsibility current and in writing?	—						
2. Do the delegations of authority and responsibility reflect the segregation of duties concept?	—	—					
3. Are the job descriptions descriptive of the jobs actually performed?	—	—					
4. Do the delegations of authority and responsibility grant officials necessary authority to carry out functions for which they are responsible?	—	—					
5. Are employees held accountable for performance and results achieved?	—	—					
6. Do managers routinely follow-up on delegations of authority and responsibility to subordinates?	—	—					
<b>.090 E. Management Control Methods</b>							
1. Is there a long-range planning process?	—	—					
2. Is the budgeting system integrated with the planning process?	—	—			—		
3. Are plans and budgets effectively communicated throughout the organization?	—	—			—		
4. Are responsibilities for budget preparation, adoption, execution, and reporting segregated?	—	—			—		
5. Is a budget calendar used for the orderly submission and approval of the budget?	—	—					
6. Are budgets prepared for all significant activities regardless of whether mandated by law?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
7. Is the budget prepared in sufficient detail providing a meaningful tool with which to monitor subsequent performance?	—	—			—		
8. Is citizen input obtained through budget hearings?	—	—	—				
9. Has the budget been submitted to the legislative body for approval and is there clear communication to operation departments or agencies of the effects of legislatively mandated budget modifications, either increases or decreases?	—						
10. Are interfund and interdepartmental transfers included in the budget?	—	—			—		
11. Is the type of budgeting performed compatible with the accounting system?	—	—			—		
12. Are budgets published if required by law?	—				—		
13. Are estimated revenues and appropriations recorded in the accounting records for later comparison to actual amounts realized or incurred?	—	—		—	—		
14. Have procedures been adopted and communicated establishing authority and responsibility for transfers between budget categories?	—	—	—		—		
15. Is the flow of expenditures or commitments controlled through the use of an allotment system?	—	—	—				
16. Does the accounting department submit approval as to availability of funds before the issuance of a purchase order or expenditure commitment?	—	—	—				
17. Are requests for supplemental appropriations or budget changes processed and approved in the same manner as the original budget is processed and approved?	—	—	—		—		
18. If liabilities and expenditures are recorded on an encumbrance or obligation basis, are there controls to ensure knowledge of outstanding commitments?	—	—	—		—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Complete- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
19. Are actual expenditures compared to budget with reasonable (monthly) frequency and on a timely basis?		—		—	—		
20. Are reports discussed with departmental personnel and are there explanations for significant variations from budget?		—		—	—		
21. Are executive and legislative branches notified of expenditures in excess of appropriations or budgets?	—		—		—		
22. Are actual results of operations against budget published if required by law?	—	—		—	—		
23. Are the adequacy and effectiveness of the internal control structure policies and procedures relevant to the entity's transaction classes and are account balances periodically evaluated?	—	—			—		
24. Are measures implemented to correct weaknesses?	—						
25. Are there clearly established levels of operational and financial accountability?	—	—					
26. Are program evaluations/ management reviews routinely performed?	—	—			—		
27. Are audits routinely performed?	—	—			—		
28. Are procedures in place and adhered to which require prompt implementation of resolved audit findings or program/management review results?	—	—			—		
29. Are policies and procedures current and in writing?	—						
30. Are policies and procedures consistent with statutory authorities?	—	—	—				
31. Are all policies and procedures clearly stated and systematically communicated (manuals, handbooks, etc.)?	—	—					
32. Do the policies and procedures support the internal control structure?	—	—					
33. Are there channels of communication for people to report suspected improprieties?							

	ASSERTIONS						Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	
a. Ability to contact someone other than a direct supervisor?	—	—					
b. Anonymity permitted?	—						
34. Is feedback provided to people who report suspected improprieties and do they have immunity from reprisals?	—	—					
a. Is management receptive to such reports?	—						
35. Are outside parties made aware for the entity's ethical standards?	—						
36. Is there timely and appropriate follow-up action by management resulting from external party communications, such as:							
a. Customer complaints?	—	—					
b. Notification of errors in billings?	—	—		—	—		
c. Notification of inappropriate behavior by an employee?	—						
37. Are there mechanisms to identify and react to changes that can have a more dramatic and pervasive effect on the entity, and may demand the attention of senior management? Some examples include:							
a. New laws or regulations that affect the entity or its activities,	—	—					
b. New or redesigned information systems,	—	—			—		
c. New technology incorporated into the information systems.	—	—			—		
<b>.100 F. External Influences</b>							
1. Is the organization subject to external forces or pressures which make it vulnerable to errors?	—	—			—		
2. Does the public perceive this organization to be adequately controlled?	—				—		
Phase 1:	L M	L M	L M	L M	L M		
Preliminary Risk Assessment	H	H	H	H	H		
Phase 2:	L M	L M	L M	L M	L M		
Final Risk Assessment—Based on audit tests of controls	H	H	H	H	H		



II. Accounting System

- .110 The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The auditor should obtain knowledge of the accounting system to understand:
- The classes of transactions in the entity's operations that are significant to the financial statements.
  - How those transactions are initiated.
  - The accounting records, supporting documents, computer media, and specific accounts in the financial statements involved in the processing and reporting of transactions.
  - The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
  - The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- .120 The following questions are to assist the auditors in obtaining an understanding of the accounting system and assessing the control risks.

.130 A. General

1. Does the entity have adequate written statements and explanations of its accounting policies and procedures? (Written accounting policies and procedures may include such matters as:
- (i) Chart of accounts accompanied by explanations of the items to be included in the various accounts.
  - (ii) Identification and description of the principal accounting records, recurring standard entries, and requirements for supporting documentation. For example, this may include information about the general, ledger, source journals subsidiary ledgers, and detail records for each significant class of transactions.

ASSERTIONS						Audit Tests of Controls	Substantive Tests
Existence or Occurrence	Complete- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference	
—	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	<i>Existence or Occurrence</i>	<i>Complete- ness</i>	<i>Rights and Obligations</i>	<i>Valuation or Allocation</i>	<i>Presentation and Disclosure</i>	<i>Program or W/P Reference</i>	<i>Program Reference</i>
<p>(iii) Expression of the assignment of responsibilities and delegation of authority including identification of the individuals or positions that have authority to approve various types of recurring and non-recurring entries.</p> <p>(iv) Explanations of documentation and approval requirements for various types of recurring and non-recurring transactions and journal entries. Documentation requirements, for example, would include the basis and supporting computations required for adjustments and write-offs.</p> <p>(v) Instructions for determining an adequate cutoff and closing of accounts for each reporting period.)</p>							
2. Are accounting policy and procedure manuals updated as necessary?	—	—					
3. Are manuals distributed to appropriate personnel?		—					
4. Do procedures exist to ensure that only authorized persons can alter or establish a new accounting principle, policy, or procedure to be used by the entity?	—	—	—	—	—		
5. Does the principal accounting officer of the entity have adequate authority over accounting employees and principal accounting records at all locations?	—	—					
6. Are the principal accounting, treasury, and custody functions segregated?	—	—					
7. Are the responsibilities for maintaining the general ledger segregated from those for maintaining subsidiary ledgers?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Complete- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
8. Are the responsibilities for maintaining the general ledger and custody of assets segregated?		—					
9. Is access to the general ledger and related records restricted to those who are assigned general ledger responsibilities?	—						
10. Are there adequate facilities for custody of the general ledger and related records? (Examples of such facilities include fire-resistant locked cabinets, vaults, physical barriers, separate rooms, limited access to work areas, alarms, and other detection devices.)	—						
11. Is appropriate insurance coverage maintained in amounts required by statutes or entity policy? (Such insurance may include loss of records coverage and fidelity bonding of employees in positions of trust.)	—			—			
12. Are the preparation and approval functions for journal entries segregated?	—	—		—			
13. Are all journal entries reviewed and approved by designated individuals at appropriate levels in the entity? (The levels at which journal entries are reviewed and approved will usually vary depending on whether the entries are recurring, or non-recurring, routine or unusual, accumulations of routine transactions, or adjustments of balances requiring estimates and judgments.)	—	—		—			
14. Are all journal entries adequately explained and supported? (Explanation and support for an entry should be sufficient to enable the person responsible for its review and approval to reasonably perform this function.)	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
15. Do all journal entries include approval in accordance with management's general or specific authorization?	—	—					
16. Are all journal entries subject to controls over completeness of processing? (Examples of controls over completeness of processing include pre-numbering of journal vouchers and accounting for all numbers used, accumulation of control totals of dollar amounts debited and credited, and standard identification numbers for recurring entries.)	—	—					
17. Do all journal entries include adequate identification of the accounts in which they are to be recorded?	—	—		—	—		
<b>.140 B. Electronic Data Processing</b>							
<b>Segregation of Duties</b>							
1. Is the EDP department independent from the accounting and operating departments for which it processes data?	—						
2. Does appropriate segregation of duties exist within the data processing function for (a) systems development (design and programming), (b) technical support (maintenance of systems software), and (c) operations?	—	—					
3. In smaller and minicomputer installations with limited opportunities for segregation of duties, do procedures exist for user departments to—							
● Utilize batch or other input controls?							
● Control master file changes?							
● Balance master files between processing cycles?	—	—		—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
4. Do the personnel policies of the EDP function include such procedures as reference checks, security statements, rotation of duties, and terminated employee security measures that enhance segregation of duties and otherwise improve controls?	—						
<b>Procedural Controls</b>							
<b>User Controls</b>							
5. Do controls exist over preparation and approval of input transactions outside the EDP department and is the department prohibited from initiating transactions?	—	—					
6. Does the user exercise control procedures over input to ensure that all approved input is processed correctly through the system and only once?	—	—		—			
7. Do controls exist over entry of data in on-line systems to restrict access to terminals and data entry to authorized employees?	—	—					
8. Do on-line systems controls exist that prevent documents from being keyed into the system more than once and that permit tracing from computer output to data source and vice versa?	—	—					
9. Do controls exist over changes to master files, such as requiring preparation of specific forms indicating data to be changed, approval by a supervisor in the user department, and verifying against a printout of changes?	—	—					
10. Do user controls exist over rejected transactions through the use of a computerized suspense file of rejected transactions or an auxiliary manual system?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
11. Does user department management reconcile output totals to input totals for all data submitted, reconcile the overall file balances, and review outputs for reasonableness?	—	—		—			
<b>Application Controls</b>							
12. Do procedures exist within the data processing control function that provide that data is properly controlled between the user and the EDP department?	—	—					
13. Do controls exist over data entry, for example, that include adequate supervision, up-to-date instructions, key verification of important fields, and self-checking digits?	—	—					
14. Do program controls exist over entry of data into on-line systems?	—	—					
15. Is input data edited and validated?	—	—					
16. Do data processing controls exist over rejected transactions?	—	—					
17. Do controls exist for balancing transactions and master files?	—	—		—			
18. Do procedures exist within the data processing control function concerning review and distribution of output?	—	—					
<b>General Controls</b>							
19. Do controls exist over changes to system software?	—	—					
20. Do controls exist over use and retention of tape and disk files, including provisions for retention of adequate records to provide backup capabilities?	—	—					
21. Do controls exist that limit access to data processing equipment, tapes, disks, system documentation, and application program documentation to authorized employees?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Complete- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
22. Is a job accounting system (or console logs) used to ensure that scheduled programs are processed and proper procedures followed and that supervisory personnel know that only required programs have been processed?	—	—					
23. Are EDP department employees supervised for all shifts?	—	—					
24. Are procedures to be followed by computer operators documented?	—	—					
25. Is the data processing system documented such that the organization could continue to operate if important data processing employees leave?	—						
26. Do procedures exist to protect against a loss of important files, programs, or equipment?	—	—					
27. Are equipment, programs, and data files covered by insurance?	—						
28. Are there user-approved written specifications for new systems and modifications to existing application systems?	—	—					
29. Are there written procedures to test and implement new systems and modifications to existing application systems?	—	—					
<b>.150 C. Financial Reporting</b>							
<b><i>Segregation of Duties</i></b>							
1. Is the final review and approval of financial reports segregated from the responsibility for preparation of the reports?	—	—					
<b>Procedural Controls</b>							
<b><i>General Ledger</i></b>							
2. Is there a formal plan of organization for the unit of government under which reporting responsibilities are clearly defined and reasonably aligned?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
3. Is the principal accounting officer over accounting records and accounting employees supervised at all locations?	—	—					
4. Is there general ledger control over all assets and transactions of all departments of the organization?	—	—		—			
<b>Closing</b>							
5. Are procedures and policies for closing the accounts for a reporting period sufficient to ensure that accounts are closed, adjusted, and reviewed on a timely basis?	—	—		—			
6. Do procedures exist to ensure that all accounting systems have included all transactions applicable to the reporting period?		—					
7. Are valuation reserves or other account balances based on estimates reviewed and approved?	—			—			
8. Are all journal entries reviewed, approved, and supported by adequate descriptions or documentation?	—	—					
9. Do controls exist that ensure that only authorized individuals can initiate entries?	—						
<b>Combining</b>							
10. Do procedures exist to ensure the orderly and effective accumulation of financial data?	—	—			—		
11. Do procedures exist for the orderly processing of financial data received from departments and other accounting units?	—	—			—		
12. Do procedures exist to permit the recording and review of special entries generated in the combining process?	—	—			—		
<b>Preparation, Review and Approval</b>							
13. Do procedures exist to ensure that financial reports are supported by either underlying account records or other documentation?	—						



	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	<i>Existence or Occurrence</i>	<i>Complete- ness</i>	<i>Rights and Obligations</i>	<i>Valuation or Allocation</i>	<i>Presentation and Disclosure</i>	<i>Program or W/P Reference</i>	<i>Program Reference</i>
14. Do procedures exist provid- ing reasonable assurances that all data required to be included in legal as well as public reports are properly disclosed?		—			—		
15. Do procedures exist to en- sure that financial reports are prepared on a consistent ba- sis?	—	—			—		
16. Are financial reports re- viewed and approved at ap- propriate levels of management and, if appro- priate, by the legislature before public release?	—				—		
17. Are there procedures to ensure that all require- ments for filing of finan- cial reports are met (for example, senior levels of government, bondholders, and the public)?	—	—		—			
<b>.160 D. Identified Significant Account Balances and Transaction Classes</b>							
1. Cash?	—						
2. Investments?	—						
3. Revenues and Receivables?	—						
4. Capital Assets?	—						
5. Procurement and Payables?	—						
6. Employee Compensation?	—						
Phase 1:	L	L	L	L	L		
	M	M	M	M	M		
Preliminary Risk Assessment	H	H	H	H	H		
Phase 2:	L	L	L	L	L		
	M	M	M	M	M		
Final Risk Assessment—Based on audit tests of controls	H	H	H	H	H		

III. Control Procedures

- .170 Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to—
- Proper authorization of transactions and activities.
  - Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
  - Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of pre-numbered shipping documents.
  - Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
  - Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.
- .180 Questions for the following functional areas have been included to assist the auditor in obtaining an understanding of the control procedures and assessing the control risk:
- Cash
  - Investments
  - Revenues and Receivables
  - Capital Assets
  - Procurement and Payables
  - Employee Compensation

.190 A. Cash

*Segregation of Duties*

1. Are responsibilities for collection and deposit preparation functions segregated from those for recording cash receipts and general ledger entries?

ASSERTIONS					Audit Tests of Controls	Substantive Tests
Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Comple- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
2. Are responsibilities for cash receipts functions segregated from those for cash disbursements?		—					
3. Are responsibilities for disbursement preparation and disbursement approval functions segregated from those for recording or entering cash disbursements information on the general ledger?	—	—		—			
4. Are responsibilities for the disbursement approval function segregated from those for the disbursement, voucher preparation, and purchasing functions?	—			—			
5. Are responsibilities for entries in the cash receipt and disbursement records segregated from those for general ledger entries?	—	—					
6. Are responsibilities for preparing and approving bank account reconciliations segregated from those for other cash receipts or disbursement functions?	—	—			—		
7. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
<b>Procedural Controls</b>							
<i>Collections</i>							
8. Are all receipts deposited on a timely basis (preferably daily)?		—					
9. Do controls exist over the collection, timely deposit, and recording of collections in the accounting records in each collection location?		—					
10. Is the general accounting department notified on a timely basis of cash receipts from separate collection locations?		—					
11. Are daily reported receipts compared on a test basis to bank statements to verify timeliness of deposits?	—						
12. Is a restrictive endorsement placed on each incoming check upon receipt?		—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
13. Are "not sufficient funds" checks delivered to someone independent of processing and recording of cash receipts?		—					
14. Do procedures exist for follow-up of "not sufficient funds" checks?		—					
15. Do controls exist to ensure that checks are returned promptly for deposit if checks received are forwarded to be used as posting media to taxpayers' or customers' accounts?		—					
16. Are receipts controlled by cash register, pre-numbered receipts, or other equivalent means if payments are made in person (over the counter)?		—					
17. Are receipts accounted for and balanced to collections on a daily basis?	—	—					
18. Do facilities exist for protecting undeposited cash receipts?	—	—					
<i>Disbursements</i>							
19. Does control exist over warrant or check-signing machines as to signature plates and usage?	—	—					
20. Are procedures provided for immediate notification to banks when warrant or check signers leave the unit or are otherwise no longer authorized to sign?	—	—					
21. Are invoices and supporting documents furnished to the signer prior to signing the warrant or check?	—	—		—			
22. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						
23. Are two signatures required on warrants or checks over a stated amount?	—						
24. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
25. Are signature plates under the signer's control when in use?	—	—					
26. Is the recording machine read by the signer or an appropriate designee to ascertain that all checks or warrants signed are properly accounted for by comparison to document control totals?	—	—					
27. Are signed warrants or checks delivered directly to the mailroom making them unaccessible to persons who requested, prepared, or recorded them?	—						
28. Is the drawing of warrants or checks to cash or bearer prohibited?	—						
<i>Custody</i>							
29. Are controls maintained over the supply of unused and voided warrants or checks?	—	—					
30. Are bank accounts properly authorized?		—					
31. Are depositories periodically reviewed and formally reauthorized?		—					
32. Do controls and physical safeguards exist surrounding working (petty cash) funds?	—						
33. Is adequate fidelity insurance maintained?	—	—	—				
34. Are separate bank accounts maintained for each fund, or if not, is there adequate fund control over pooled cash?			—		—		
<i>Detail Accounting</i>							
35. Do procedures exist to ensure that collections and disbursements are recorded accurately and promptly?		—		—	—		
36. Do procedures exist for authorizing and recording interbank and interfund transfers and for providing for proper accounting for those transactions?	—	—		—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<i>General Ledger</i>							
37. Does general ledger control exist over all bank accounts?	—	—					
38. Are bank statements and paid warrants or checks delivered in unopened envelopes directly to the employee preparing the reconciliation?	—	—			—		
39. Do procedures exist for steps essential to an effective reconciliation, particularly—							
● Comparison of warrants or checks in appropriate detail with disbursement records?		—		—			
● Examination of signature and endorsements, at least on a test basis?	—		—				
● Accounting for numerical sequence of warrants or checks used?		—		—			
● Comparison of book balances used in reconciliations with general ledger accounts?	—	—		—	—		
● Comparison of deposit amounts and dates with cash receipt entries?		—		—			
● Footing of cash books?		—		—			
40. Are all reconciliations and investigations of unusual reconciling items reviewed and approved by an official who is not responsible for receipts and disbursements, including recording evidence of the review and approval by signing the reconciliation?	—	—		—			
41. Are checks outstanding for a considerable time periodically reviewed for propriety?	—						
Phase 1:	L M	L M	L M	L M	L M		
Preliminary Risk Assessment	H	H	H	H	H		
Phase 2:	L M	L M	L M	L M	L M		
Final Risk Assessment—Based on audit tests of controls	H	H	H	H	H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<b>.200 B. Investments</b>							
<b><i>Segregation of Duties</i></b>							
1. Are responsibilities for initiating, evaluating, and approving transactions segregated from those for detail accounting, general ledger, and other related functions?	—	—		—			
2. Are responsibilities for initiating transactions segregated from those for final approvals that commit government resources?	—			—			
3. Are responsibilities for monitoring investment market values and performance segregated from those for investment acquisition?	—			—			
4. Are responsibilities for maintaining detail accounting records segregated from those for general ledger entries?	—			—			
5. Are custodial responsibilities for securities or other documents evidencing ownership or other rights assigned to an official who has no accounting duties?	—		—	—			
6. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
<b><i>Procedural Controls</i></b>							
<b><i>Approval</i></b>							
7. If applicable, are procedures adequate to ensure that only investments that are permitted by law are acquired?	—			—	—		
8. Are investment policy guidelines formally established and periodically reviewed?	—				—		
9. Is the investment program integrated with the cash management program and expenditure requirements?	—	—		—			
10. Have authority and responsibility been established for investment opportunity evaluation and purchase?	—			—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
11. Is the performance of the investment portfolio periodically evaluated by persons independent of investment portfolio management activities?	—	—		—			
12. Are procedures formally established governing the level and nature of approvals required to purchase or sell an investment?	—			—			
13. Are competitive bids sought for certificate of deposit purchases?	—			—			
<i>Custody</i>							
14. Do adequate physical safeguards and custodial procedures exist over—							
● Negotiable and nonnegotiable securities owned?	—		—				
● Legal documents or agreements evidencing ownership and other rights?	—		—				
15. Are dual signatures or authorizations required to obtain release of securities from safekeeping or to obtain access to the government unit's safe deposit box?	—		—				
16. Are persons with access to securities authorized by the legislative body?	—	—	—				
17. Are all securities registered in the name of the government unit?	—		—				
18. Are securities periodically inspected or confirmed from safekeeping agents?	—		—	—			
19. Are individuals with access to securities bonded?			—				
<i>Detail Accounting</i>							
20. Are detail accounting records maintained for investments?	—	—		—	—		
21. Do procedures exist to ensure that transactions arising from investments are properly processed, including income and amortization entries?	—	—		—	—		
22. Do controls exist to ensure that investment earnings are credited to the fund from which resources were provided for the investment?				—	—		



	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
23. Are periodic comparisons made between income received and the amount specified by the terms of the security or publicly available investment information?	—			—	—		
24. Do controls exist to ensure that transactions are recorded on a timely basis?		—		—	—		
<i>General Ledger</i>							
25. Do procedures exist for reconciling the detail accounting records with the general ledger control?	—			—	—		
26. Is the nature of investments included in general ledger balances periodically reviewed?	—			—	—		
Phase 1:	L	L	L	L	L		
	M	M	M	M	M		
Preliminary Risk Assessment	H	H	H	H	H		
Phase 2:	L	L	L	L	L		
	M	M	M	M	M		
Final Risk Assessment—Based on audit tests of controls	H	H	H	H	H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<b>.210 C. Revenues and Receivables</b>							
<b><i>Segregation of Duties</i></b>							
1. Are the responsibilities for billing property taxes and services segregated from collection and accounting?		—		—			
2. Are the responsibilities for maintaining detail accounts receivable records segregated from collections and general ledger posting?	—	—		—			
3. Are the collection, control, and deposit of funds activities segregated from the accounting records maintenance function?	—	—		—			
4. Are property tax assessment rolls maintained by individuals not engaged in any accounting or collection function?	—	—		—			
5. Are responsibilities for entries in the cash receipts records segregated from those for general ledger entries?	—	—					
6. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
<b><i>Procedural Controls</i></b>							
<b><i>Data and File Maintenance</i></b>							
<b>Property Taxes</b>							
7. Do controls exist to ensure that additions, deletions, transfers, and abatements are properly and timely reflected in property tax records?		—		—			
8. Do procedures exist to make property assessments in accordance with the law or legislative intent with prompt adjustment of records?		—	—	—			
<b>Sales, income, and other taxes</b>							
9. Are filed returns cross-referenced against a data base of previous taxpayers?		—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
10. Are records organized and integrated in such a fashion that probable taxpayers are identified as a result of reporting of other governmental activities such as licensing?		—					
License fees and permits							
11. If annual payments are involved, do procedures exist to ensure that previous years' records are properly updated for new registrants and withdrawals?	—	—					
12. Are updated records used as the basis for billing persons subject to payment?		—		—			
Fines, forfeitures, and court fees							
13. Are court and other records of payments due maintained and used as a basis for collections?		—		—			
14. Do procedures exist surrounding the control, issuance, and disposition of traffic violations to ensure that amounts due are assessed and collected?		—					
Enterprise and other service revenues							
15. Are controls maintained that provide assurances that customer data base and, where appropriate, usage records are accurately maintained to ensure that amounts due are billed?	—	—					
<i>Billing/Remittance Verification</i>							
Property Taxes							
16. Do controls exist within the billing system to ensure that eligible property owners are billed?		—		—			
17. Do controls exist to ensure that tax assessments are being properly applied against tax rates and special charges are being considered in the preparation of billing amounts?			—	—			
18. Do controls exist to ensure that tax exemptions are within the law and properly approved?	—		—	—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
Sales, income, and other taxes							
19. Are returns reviewed for mathematical accuracy?				—			
20. Are current year's taxpayers' returns correlated with prior year's returns and are differences reviewed and accounted for?		—		—			
21. Are claims for refunds reviewed and approved separately?	—		—	—			
22. Are audits of returns filed to provide reasonable assurance that taxable income is properly reported?			—	—			
License fees and permits							
23. Are current year receipts compared to those for prior years and are explanations of variations reviewed by senior officials?		—		—			
Fines, forfeitures, and court fees							
24. Do procedures exist providing for correlation of amounts collected with records of court proceedings?	—	—	—	—			
25. Are tickets for fines, arrests, and so forth sequentially numbered and satisfactorily accounted for?		—					
Enterprise and other service revenues							
26. If billing is based on usage, are service readings performed in a timely fashion?	—	—	—				
27. Are assignments of meter readers periodically rotated?		—	—				
28. Do billing procedures exist providing for identification and investigation of unusual patterns of use?	—	—					
General							
29. Are taxes and fees billed in a timely fashion?		—					
30. Do procedures exist designed for other revenue areas ensuring timely payment of amounts due?		—	—	—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
31. Are rates of taxes, fines, fees, and services periodically reviewed and approved by the legislative body?			—	—			
32. Are programs of tax exemption or relief periodically reviewed and approved by the legislative body?			—	—			
33. Are utility rate schedules authorized by the legislative body?			—	—			
34. Do procedures exist providing for timely notification of the accounting department at the time tax, service, or other billings or claims are prepared and rendered?		—		—			
35. Do numerical or batch-processing controls exist over tax, fee, service, or other billings?		—					
36. Do controls exist over the billing of miscellaneous revenues (for example, sidewalk replacement and tree removal assessments)?	—	—	—	—			
37. Do procedures exist to prevent the interception or alteration by unauthorized persons of billings or statements after preparation but before they are mailed?		—		—			
38. Does an individual independent of receivables record keeping promptly investigate disputes with billing amounts that are reported by taxpayers or service recipients?	—		—	—			
39. Do controls exist providing reasonable assurances that restricted revenues are expended only for restricted purposes?			—	—	—		
<i>Collection</i>							
40. Is restrictive endorsement placed on incoming checks as soon as received?		—					
41. Do procedures exist providing reasonable assurances that interest and penalties are properly charged on delinquent taxes, fees, or charges for service?		—	—	—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
42. Do procedures exist providing for the timely filing of liens on property for non-payment in all cases permitted by law?			—				
43. Do controls exist surrounding the collection, timely deposit, and recording of collections in the accounting records at each collection location?		—					
44. Is the general accounting department notified of cash receipts from separate collection centers on a timely basis?		—					
45. If payments are made in person, are receipts for payment used and accounted for and balanced to collections?	—	—					
46. Are amounts collected on behalf of other governments segregated and remitted on a timely basis?			—	—	—		
47. Are taxes and fees collected by another unit of government monitored to assure timely receipt and are amounts received subjected to reviews for reasonableness?		—	—	—			
48. Are delinquent accounts reviewed and considered for charge-off on a timely basis?			—	—	—		
49. Are write-offs or other reductions of receivables formally approved by senior officials not involved in the collection function?					—		
50. Do procedures exist providing for execution of all legal remedies to collect charged-off or uncollectible accounts, including tax sale of property, liens, and so forth?				—	—		
<i>Accounts Receivable Record Keeping</i>							
51. Do controls in the system exist that provide assurances that individual receivable records are posted only from authorized source documents?	—			—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Comple- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
52. Are aggregate collections on accounts receivable reconciled against postings to individual receivable accounts?		—		—			
53. Are statements of account balance mailed on a timely basis, where appropriate (for example, in proprietary funds)?			—	—			
<i>General Ledger</i>							
54. Are trial balances of individual receivable accounts prepared on a timely basis?				—			
55. Are trial balances reconciled with general ledger control accounts and are reconciling items investigated by someone other than accounts receivable clerks?		—		—			
56. Are aged accounts receivable balances periodically reviewed by supervisory personnel?				—	—		
57. Do procedures exist for providing for timely and direct notification of the accounting department of billings and collection activities?		—		—			
<i>Grant and Entitlement Monitoring</i>							
<i>Grants</i>							
58. Is responsibility for monitoring grant activities properly fixed?			—				
59. Is grant activity monitored from a centralized location?	—		—				
60. Do procedures exist to monitor compliance with—							
• Financial Reporting requirements?			—				
• Use of funds and other conditions in accordance with grant terms?	—		—	—			
• Timely billing of amounts due under grants?		—	—				
61. Is grant activity accounted for so that it can be separated from the accounting for locally funded activities?				—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
62. Is there a system for obtaining grantor approval before incurring expenditures in excess of budgeted amounts or for unbudgeted expenditures?			—				
63. Are grant revenues and disbursements processed under the same degree of controls applicable to the organization's other transactions (budget, procurement, etc.)?	—	—	—	—	—		
64. Are requirements included in subgrantee agreements that the subgrantee comply with the primary grant agreement conditions as well as the grantee's standards?			—				
65. Do reasonable procedures and controls exist to provide assurances of compliance with recipient eligibility requirements established by grants?			—				
66. Is an indirect cost allocation plan established?	—		—	—			
67. Is the plan approved by all grantor agencies?			—	—			
68. Is the audit cognizance established for rates generated by the plan?				—			
<b>Entitlements</b>							
69. Is the amount of funds received compared with the amount anticipated by a responsible official and are unusual variances investigated?		—		—			
70. Do procedures exist to ensure that funds received are spent in accordance with legal requirements and spending restrictions?			—				
71. Are statistical or data reports that form the basis for revenue distribution reviewed by a responsible official before submission?	—			—			
Phase 1:	L M H	L M H	L M H	L M H	L M H		
Preliminary Risk Assessment							



Phase 2:

Final Risk Assessment—Based  
on audit tests of controls

ASSERTIONS					Audit Tests of Controls	Substantive Tests
<i>Existence or Occurrence</i>	<i>Complete- ness</i>	<i>Rights and Obligations</i>	<i>Valuation or Allocation</i>	<i>Presentation and Disclosure</i>	<i>Program or W/P Reference</i>	<i>Program Reference</i>
L	L	L	L	L		
M	M	M	M	M		
H	H	H	H	H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<b>.220 D. Capital Assets</b>							
<b><i>Segregation of Duties</i></b>							
1. Are responsibilities for initiating, evaluating, and approving capital expenditures, leases, and maintenance or repair projects segregated from those for project accounting, property records, and general ledger functions?	—	—					
2. Are responsibilities for initiating capital asset transactions segregated from those for final approvals that commit government resources?	—	—		—			
3. Are responsibilities for the project accounting and property records functions segregated from the general ledger function?	—	—		—			
4. Are responsibilities for the project accounting and property records functions segregated from the custodial function?	—	—					
5. Are responsibilities for the periodic physical inventories of capital assets assigned to responsible officials who have no custodial or record keeping responsibilities?	—	—					
6. If EDP is used, is the principle of segregation of duties maintained within processing activities?		—					
<b><i>Procedural Controls</i></b>							
<b><i>Authorization</i></b>							
7. Are those individuals authorized to initiate capital asset transactions identified and is there clear definition of the limits of their authority?	—						
8. Are guidelines established with respect to key considerations such as prices to be paid, acceptable vendors and terms, asset quality standards, and the provisions of grants or bonds that may finance the expenditures?	—						
9. Is a separated capital projects budget prepared?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<i>Executive or Legislative Approval</i>							
10. Is written executive or legislative approval required for all significant capital asset projects or acquisitions?	—						
11. Do procedures exist for authorizing, approving, and documenting sales or other dispositions of capital assets?	—	—					
12. Do procedures exist for approving decisions regarding financing alternatives and accounting principles, practices, and methods?	—			—			
13. Do procedures exist providing for obtaining grantor (federal/state) approval, if required, for the use of grant funds for capital asset acquisitions?	—		—				
14. Are grant-funded acquisitions subjected to the same controls as internally funded acquisitions?	—	—					
15. Are supplemental authorizations required, including, if appropriate, those of the grantor agency, for expenditures in excess of originally approved amounts?	—	—					
<i>Project Accounting</i>							
16. Is a qualified employee or independent firm engaged to inspect and monitor technically complex projects?	—	—		—			
17. Are project cost records established and maintained for capital expenditure and repair projects?	—	—		—			
18. Do reporting procedures exist for in-progress and completed projects?					—		
19. Do procedures exist to identify completed projects so that timely transfers to the appropriate accounts can be made?	—	—			—		
20. Is the accounting distribution reviewed to ensure proper allocation of charges to fixed asset and expenditure projects?				—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
21. If construction work is performed by contractors, do procedures exist to provide for and maintain control over construction projects and progress billings?	—		—	—			
22. Does the unit of government have the right to audit contractors' records?	—	—	—	—			
23. Is the right to audit contractor records during project performance exercised?	—		—				
24. Do audits of contractors cover compliance with EEO, Davis Bacon, and other regulations and contract terms, in addition to costs?	—	—		—	—		
<i>Asset Accountability</i>							
25. Are detail property records maintained for all significant self-constructed, donated, purchased, or leased assets?	—	—					
26. Is the accountability for each asset established?	—	—					
27. Do procedures exist for periodic inventory of documents evidencing property rights (for example, deeds, leases, and the like)?	—	—		—			
28. Do physical safeguards over assets exist?	—	—					
29. Do procedures exist ensuring that purchased materials and services for capital expenditure and repair projects are subjected to the same levels of controls as exist for all other procurements (for example, receiving, approval, checking)?	—	—					
30. Are detailed property records periodically compared with existing assets?	—	—		—			
31. Are differences between records and physical counts investigated and are the records adjusted to reflect shortages?	—			—			
32. Do procedures exist ensuring that capital assets are adequately insured?	—			—			
33. Are lease transactions subjected to control procedures similar to those required for other capital expenditures?	—	—	—				

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
34. Is equipment properly identified by metal numbered tags or other means of positive identification?	—			—			
35. Are fully depreciated assets carried in the accounting records as a means of providing accounting control?	—	—					
36. Do procedures exist for monitoring the appropriate disposition of property acquired with grant funds?	—		—				
<i>General Ledger</i>							
37. Are detailed property records periodically reconciled with the general ledger control accounts?	—	—		—			
38. Do procedures and policies exist to—							
• Distinguish between capital projects' fund expenditures and operating budget expenditures?			—	—			
• Identify operating budget expenditures to be capitalized in the fixed asset fund?					—		
• Distinguish between capital and operating leases?			—		—		
• Govern depreciation methods and practices?				—			
39. If costs are expected to be charged against federal grants, are depreciation policies or methods of computing allowances in accord with the standards outlined in OMB circulars or grantor agency regulations; if not, is depreciation charged to grants adjusted accordingly?			—	—			
40. Are the accounting records adjusted promptly—both the asset and related allowance for depreciation—when items of plant and equipment are retired, sold, or transferred?	—		—	—	—		
Phase 1:	L M	L M	L M	L M	L M		
Preliminary Risk Assessment	H	H	H	H	H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	<i>Existence or Occurrence</i>	<i>Complete- ness</i>	<i>Rights and Obligations</i>	<i>Valuation or Allocation</i>	<i>Presentation and Disclosure</i>	<i>Program or W/P Reference</i>	<i>Program Reference</i>
Phase 2:	L	L	L	L	L		
	M	M	M	M	M		
Final Risk Assessment—Based on audit tests of controls	H	H	H	H	H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<b>.230 E. Procurement and Payables</b>							
<b><i>Segregation of Duties</i></b>							
1. Are responsibilities for the requisitioning, purchasing, and receiving functions segregated from the invoice processing, accounts payable, and general ledger functions?	—	—					
2. Are responsibilities for the purchasing function segregated from the requisitioning and receiving functions?	—	—					
3. Are responsibilities for the invoice processing and accounts payable functions segregated from the general ledger functions?	—	—		—			
4. Are responsibilities for the disbursement preparation and disbursement approval functions segregated from those for recording cash disbursements and general ledger entries?	—	—		—			
5. Are responsibilities for the disbursement approval function segregated from those for the disbursement preparation function?	—	—					
6. Are responsibilities for entries in the cash disbursement records segregated from those for general ledger entries?	—	—		—			
7. If EDP is used, is the principle of segregation of duties maintained within processing activities?	—	—					
<b><i>Procedural Controls</i></b>							
<b><i>Requisitioning</i></b>							
8. Are purchases of goods and services initiated by properly authorized requisitions bearing the approval of officials designated to authorize requisitions?	—						
9. Are requisitions pre-numbered and are those numbers controlled?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
10. Is the appropriation to be charged indicated on the purchase requisition by the person requesting the purchase?	—				—		
11. Before commitment, are unobligated funds remaining under the appropriation verified by the accounting or budget department as sufficient to meet the proposed expenditure?			—	—			
12. Are requests for special purpose (nonshelf items) materials or personal services accompanied by technical specifications?	—			—			
<i>Purchasing</i>							
13. Are purchasing authorizations structured to give appropriate recognition to the nature and size of purchases and the experience of purchasing personnel?	—	—					
14. Do approval procedures exist for purchase order and contract issuance?	—	—					
15. Are purchase prices periodically reviewed by a responsible employee independent of the purchasing department?				—			
16. Are competitive bidding procedures used?				—			
17. If practicable, are contract or purchasing officer's areas of responsibility rotated on a regular basis?	—						
18. Do provisions in contracts for materials, services, or facilities acquired on other than a fixed price basis provide for an audit of contractors' costs, with payments subject to audit results?			—	—			
19. Do procedures exist for public advertisement of nonshelf item procurements in accordance with legal requirements?	—			—			
20. Are recurring purchases and documentation of the justification for informal rather than competitive bids periodically reviewed?	—			—			



	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
21. Are policies regarding conflicts of interest and business practice policies established, documented, and distributed?	—						
22. Are purchase orders and contracts issued under numerical or some other suitable control?	—	—					
23. Are an adequate number of price quotations obtained before placing orders not subject to competitive bidding?				—			
24. Is splitting orders prohibited to avoid higher levels of approval?	—			—			
25. Are price lists and other appropriate records of price quotations maintained by the purchasing department?				—			
26. Is a record of suppliers who have not met quality or other performance standards by the purchasing department maintained?	—	—					
27. Are procedures modified when funds disbursed under grant or loan agreements and related regulations impose requirements that differ from the organization's normal policies?	—		—		—		
28. Are procedures instituted to identify, before order entry, costs and expenditures not allowable under grant (federal/state) programs?			—	—			
29. Is an adequate record of open purchase orders and agreements maintained?	—		—				
30. Are purchases made for the accommodation of employees prohibited or adequately controlled?	—			—			
31. If construction contracts are to be awarded, are bid and performance bonds considered?	—		—	—			
32. Does predetermining selection criteria exist for awarding personal service or construction contracts and is adequate documentation of the award process required?				—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
33. Are changes to contracts or purchase orders subjected to the same controls and approvals as the original agreement?			—	—			
<i>Receiving</i>							
34. Are receiving reports prepared for all purchased goods?	—						
35. Do procedures exist for the filing of claims against carriers or vendors for shortages or damaged materials?	—		—	—			
36. Are steps taken to ensure that goods received are accurately counted and examined to see that they meet quality standards?	—			—			
37. Is a permanent record of material received by the receiving department maintained?	—	—		—			
38. Are receiving reports numerically accounted for or otherwise controlled to ensure that all receipts are reported to the accounting department?	—	—		—			
39. Are copies of receiving reports sent directly to purchasing, accounting, and, if appropriate, inventory record keeping?	—	—		—			
40. Is a government technical representative assigned to monitor and evaluate contractor performance and approve receipt of services with respect to procurements of special purpose materials, services, or facilities?	—	—		—			
41. If a receiving department is not used, do adequate procedures exist to ensure that goods for which payment is made have been received and are verified by someone other than the individual approving payment that goods have been received and meet quality standards?	—	—		—			
<i>Invoice Processing</i>							
42. Do invoice processing procedures provide for—							

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<ul style="list-style-type: none"> <li>● Obtainment directly from issuing departments of copies of purchase orders and receiving reports?</li> <li>● Comparison of invoice quantities, prices, and terms with those indicated on the purchase order?</li> <li>● Comparison of invoice quantities with those indicated on the receiving reports?</li> <li>● As appropriate, checking accuracy of calculations?</li> </ul>	—	—					
43. Are all invoices received from vendors in a central location, such as the accounting department?		—		—			
44. Do procedures exist ensuring that the accounts payable system is properly accounting for unmatched receiving reports and invoices?	—	—	—	—			
45. Are requests for progress payments under long-term contracts related to contractors' efforts and are they formally approved?	—		—	—			
46. Do procedures exist for processing invoices not involving materials or supplies (for example, lease or rental payments, utility bills)?	—	—					
47. Do procedures exist ensuring accurate account distribution of all entries resulting from invoice processing?	—			—	—		
48. If applicable, is access to the EDP master vendor file limited to employees authorized to make changes?	—	—					
49. Does the accounting department maintain a current list of those authorized to approve expenditures?	—						
50. Do procedures exist for submission and approval of reimbursement to employees for travel and other expenses?	—		—	—			
51. Is control established by the accounting department over invoices received before releasing them for departmental approval and other processing?	—	—		—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or WIP Reference	Program Reference
52. Is the distribution of charges in the accounting department reviewed by a person competent to pass on the propriety of the distribution?				—	—		
53. Are invoices (vouchers) reviewed and approved for completeness of supporting documents and required clerical checking by a senior employee?	—	—					
54. If an invoice is received from a supplier not previously dealt with, are steps taken to ascertain that the supplier actually exists?	—						
55. Are payments made only on the basis of original invoices?	—			—			
56. Is responsibility fixed for seeing that all cash discounts are taken and, if applicable, that exemptions from sales, federal excise, and other taxes are claimed?				—			
57. Are differences in invoice and purchase order price, terms, shipping arrangements, or quantities referred to purchasing for review and approval?	—			—			
58. Does the accounting department record and follow up partial deliveries?		—		—			
59. Are the accounting and purchasing departments promptly notified of returned purchases, and are such purchases correlated with vendor credit advices?	—			—			
60. Is the program and expenditure account to be charged reviewed for propriety and budget conformity?				—	—		
61. Do check signers or other responsible officials determine that restricted revenues are expended only for restricted purposes?			—		—		
62. If applicable, do procedures exist to ensure adjustment of the reserve for encumbrances (obligations) when invoices are prepared for payment?	—			—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<i>Disbursements</i>							
63. Do procedures exist for disbursement approval and warrant or check-signing?	—	—					
64. Is there control over warrant or check-signing machines as to signature plates and usage?	—						
65. Do procedures exist to notify banks when a new signer is authorized or a previous signer leaves the employ of the government?	—						
66. Is the signer furnished with invoices and supporting data and are they reviewed prior to signing the warrant or check?	—	—		—			
67. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						
68. Are two signatures required on all warrants or checks over a stated amount?	—						
69. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						
70. Are plates only under the signer's control used and does that person or an appropriate designee record machine readings to ascertain that all checks or warrants signed are properly accounted for?	—			—			
71. Are invoices and supporting documents cancelled by or in the presence of the signer at the time of signing?	—			—			
72. Are signed warrants or checks delivered directly to the mail room, making them inaccessible to persons who requested, prepared, or recorded them?	—						
73. Are warrants or checks cross-referenced to vouchers?	—			—			
74. Are warrants or checks controlled and accounted for with safeguards over those unused and voided?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
75. Is the drawing of warrants or checks to cash or bearer prohibited?	—						
76. Do procedures exist ensuring that warrants or checks that have been signed and issued are recorded promptly?	—	—		—	—		
<i>Accounts Payable Encumbrances or Obligations</i>							
77. Are statements from vendors compared on a regular basis with recorded amounts payable?	—			—			
78. If an encumbrance (obligation) system is used, are outstanding purchase orders reconciled to the reserve to the reserve for encumbrances (obligations) on a monthly basis?	—			—	—		
79. Are encumbrance (obligation) entries recorded only on the basis of approved purchase orders?	—				—		
80. Do procedures exist ensuring that accounts payable and encumbrances (obligations) are applied against the appropriate account?	—			—	—		
81. Do procedures exist ensuring that department heads are notified of payments made against accounts payable and encumbrances (obligations)?	—			—	—		
<i>General Ledger</i>							
82. Are trial balances of reserve for encumbrances (obligations) and accounts payable prepared on a regular basis?		—		—	—		
83. Are trial balance footings checked and traced to the individual items as well as comparing the total to the general ledger balance by an employee other than the accounts payable clerk?		—		—	—		
84. Are transactions between funds in all affected funds posted in the same accounting period and on a timely basis?				—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Complete- ness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<i>Grant and Entitlement Monitoring</i>							
85. Are grants disbursed only on the basis of approved applications?	—			—			
86. Are reporting and compliance requirements defined (for example, in regulations) and communicated to grantees?					—		
87. Do procedures exist to monitor grantee compliance with grant terms?			—		—		
88. Are financial operations of grantees subjected to periodic and timely audit?	—	—	—	—			
89. Are recipients monitored sufficiently and on a timely basis to permit curtailment of any abuse before complete funds disbursement?	—	—	—	—			
90. Are funds disbursed to grantees only on an as-needed basis?	—			—			
91. Does the level of grant approval authority appear appropriate?	—	—					
92. Is failure by grantees to meet financial reporting requirements investigated on a timely basis?			—	—	—		
93. Are grantees required to evidence correction of previously detected deficiencies before approval of an extension or renewal of a grant?	—		—		—		
94. So entitlement procedures exist ensuring that statistics or data used to allocate funds are accurately accumulated (for example, census bureau forms)?				—	—		
95. Are statements of recipient compliance required with entitlement conditions (for example, statement of assurances) to be filed and does a responsible official review them?			—		—		
96. Are audited financial statements or other compliance requirements of entitlement recipients reviewed on a timely basis and are unusual items investigated?			—	—	—		

		ASSERTIONS					Audit Tests of Controls	Substantive Tests
		<i>Existence or Occurrence</i>	<i>Complete- ness</i>	<i>Rights and Obligations</i>	<i>Valuation or Allocation</i>	<i>Presentation and Disclosure</i>	<i>Program or W/P Reference</i>	<i>Program Reference</i>
Phase 1:	Preliminary Risk Assessment	L	L	L	L	L		
		M	M	M	M	M		
		H	H	H	H	H		
Phase 2:	Final Risk Assessment—Based on audit tests of controls	L	L	L	L	L		
		M	M	M	M	M		
		H	H	H	H	H		



	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
<b>.240 F. Employee Compensation</b>							
<b><i>Segregation of Duties</i></b>							
1. Are responsibilities for supervision and timekeeping functions segregated from personnel, payroll processing, disbursement, and general ledger functions?	—	—					
2. Are responsibilities for the payroll processing function segregated from the general ledger function?	—	—		—			
3. Is payroll distribution supervised by employees—							
● Who are not responsible for hiring or firing employees?	—						
● Who do not approve time reports?	—						
● Who take no part in payroll preparation?	—						
4. Are responsibilities for initiating payments under employee benefit plans segregated from accounting and general ledger functions?	—	—		—			
5. Is the payroll bank account reconciled regularly by employees independent of all other payroll transaction processing activities?	—	—		—			
6. If EDP is used, is the principle of segregation of duties maintained in processing activities?	—	—					
<b><i>Procedural Controls</i></b>							
<b><i>Personnel</i></b>							
7. Are all changes in employment (additions and terminations), salary and wage rates, and payroll deductions properly authorized, approved, and documented?	—	—		—			
8. Are notices of additions, separations, and changes in salaries, wages, and deductions promptly reported to the payroll-processing function?		—		—			
9. Are appropriate payroll records maintained for accumulated employee benefits (vacation, pension data, etc.)?		—		—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
10. Are terminating employees interviewed as a check on departure and as a final review of any termination settlement by the personnel department?	—	—		—			
11. Do written personnel policies exist?	—	—					
12. Are controls established to ensure that payroll costs charged to grants are in compliance with grant agreements?				—	—		
13. Are payroll and personnel policies governing compensation in accordance with the requirements of grant agreements?			—	—			
14. Are wages at or above the federal minimum wage?				—			
<i>Supervision / Timekeeping</i>							
15. Are hours worked, overtime hours, and other special benefits reviewed and approved by the employee's supervisor?	—	—		—			
16. Do records and procedures exist for timekeeping and attendance?	—	—					
17. Are time cards or other time reports reviewed for completeness and approved by the employee's supervisor?	—	—					
18. If time cards are used, are they punched only by the employees to whom they are issued?	—						
19. Is the time clock placed in a position where it can be observed by a supervisor?	—						
20. Do procedures exist for authorizing, approving, and recording vacations, holidays, and sick leave and is compensatory time controlled and approved?	—			—	—		
<i>Payroll Processing</i>							
21. Do controls exist over payroll preparation?	—	—		—			
22. Are changes to the EDP master payroll file approved and documented?	—			—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
23. Is access to the EDP master payroll file limited to employees who are authorized to make changes?	—			—			
24. Are completed payroll registers reviewed and approved before disbursements are made?	—			—			
25. Are documents supporting employee benefit payments (such as accumulated vacation or sick leave) reviewed before disbursements are made?	—	—		—			
26. Are comparisons (reconciliations) of gross pay of current to prior period payrolls reviewed for reasonableness by a knowledgeable person not otherwise involved in payroll processing?	—	—		—			
27. Is the payroll (examination of authorizations for changes noted on reconciliations) reviewed by an employee not involved in its preparation?	—	—		—			
28. Is the distribution of dollars and hours of gross pay balanced with the payroll registers, and reviewed by someone independent but knowledgeable in this area?				—	—		
29. Is a comparison to amounts appropriated and budgeted included in the review?				—	—		
30. Are payroll advances to officials and employees prohibited or are they subjected to appropriate review?	—			—	—		
<i>Disbursement</i>							
31. Are signature plates and the use of the payroll check-signing machines kept under control of the official whose name appears on the signature plate or an employee to whom he has delegated that responsibility?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
32. Is a log maintained that reconciles the counter on the check-signing machine with the number of checks issued in each payroll?	—						
33. Is a separate, imprest-basis, payroll bank account maintained?	—			—			
34. Is the payroll bank account reconciled on a regular basis?	—			—			
35. Are payroll check endorsements compared, on a test basis, with signatures on file by someone independent of the payroll department?	—						
36. Is someone independent of the payroll department comparing payments made in cash, which require signed receipts, with signatures on file on a test basis?	—			—			
37. Is the supply of unused payroll checks controlled?	—			—			
38. Are employees required to provide identification before being given checks or pay envelopes?	—			—			
39. Are employees prohibited from accepting another employee's pay?	—						
40. Are unclaimed wages returned to a custodian independent of the payroll department?	—				—		
41. Do employees who distribute checks or pay envelopes make a report of unclaimed wages directly to the accounting department?	—				—		
42. Are payments of unclaimed wages made at a later date only upon Presentation of appropriate evidence of employment and are they approved by an officer or employee who is not responsible for payroll preparation or time reporting?	—						
43. Are W-2 forms compared to payroll records and mailed by employees not otherwise involved in the payroll process?		—		—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	Program or W/P Reference	Program Reference
44. Do procedures exist for investigating returned W-2s?	—			—			
45. Are payroll checks periodically distributed by the internal auditors to ascertain that employees exist for all checks prepared?	—						
<i>General Ledger</i>							
46. Do adequate account coding procedures exist for classification of employee compensation and benefit costs so that such costs are recorded in the proper general ledger account?					—		
47. Are accrued liabilities for unpaid employee compensation and benefit costs properly recorded or disclosed?		—	—	—	—		
Phase 1:	L	L	L	L	L		
	M	M	M	M	M		
Preliminary Risk Assessment	H	H	H	H	H		
Phase 2:	L	L	L	L	L		
	M	M	M	M	M		
Final Risk Assessment—Based on audit tests of controls	H	H	H	H	H		

#### IV. Administrative Controls

**.250** When conducting audits in accordance with the Single Audit Act of 1984, the auditor needs to identify the administrative controls that need to be in place in order to properly administer its federal assistance programs.

**.260** These controls are normally established by an entity based on the major requirements with which the entity must comply. Paragraphs .270 and .280 are common control procedures which need to be documented and tested to support the auditor's report on internal administrative controls.

**.270 A. General Compliance Requirements**

**1. Political Activity (Compliance Supplement)**

- a. Ordinances prohibiting partisan political activity.
- b. Posters stating the prohibition against partisan political activity.
- c. Employee policy statement, handbook or policy manual prohibiting partisan political activity.
- d. Expenditure approval process, i.e., expenditures reviewed by a person who is knowledgeable of this restriction.

**2. Davis-Bacon Act (Compliance Supplement)**

- a. The practice of obtaining prevailing wage rates published in the Federal Register or obtained from the Department of Labor and comparing these rates with rates paid by contractors or subcontractors based on payroll records submitted to the grantee.
- b. The practice of interviewing contractors' or subcontractors' laborers to verify their wage rates and to compare them to the prevailing wage rate.
- c. The practice of posting prevailing wage rates and the provisions of the Davis-Bacon Act at job sites.
- d. Existence of provisions in contracts expressly requiring compliance with Davis-Bacon Act.
- e. Assignment of responsibility to monitor contractors for compliance with contract terms, including Davis-Bacon provision.
- f. Periodic requests of the Division of Labor Standards for their findings regarding the existence of any discriminatory practices by the grantee.

**3. Civil Rights (Compliance Supplement)**

- a. Existence of a civil rights policy—prohibiting discrimination.
- b. Existence of an affirmative action policy—encouraging the use of minority firms and employment of individuals from minority groups.
- c. Methods of communicating the civil rights/affirmative action policy such as posters, notations on letterhead, etc.

- d.* Accumulation of data and preparation of periodic reports reflecting status in achieving affirmative action goals.
- e.* Designated compliance officer to receive and process civil rights inquiries and complaints.
- f.* Self-evaluation procedures to ensure compliance by grantee.
- g.* Practice of holding open meetings to ensure the public is knowledgeable of the grantee's management philosophy and major policy issues.
- h.* Practice of holding public hearings regarding such topics as the use of federal funds and the location of federally financed facilities.
- i.* Published grievance procedures.
- j.* Distribution of policies and grievance procedures via the employee handbook.

**4. Cash Management (Compliance Supplement)**

- a.* Practice of deferring request for reimbursement until after the related expenditure is incurred.
- b.* Existence of a cash log showing expenditures and cash balances for federal financial programs.
- c.* Assignment of responsibility for requesting grant drawdowns to a person who has access to and utilizes the cash log and is knowledgeable of the cash management requirements.
- d.* Utilization of adequate cash forecasting methods (when grant reimbursements are requested prior to incurring the expenditure).
- e.* Reviewed and documented approval of grant drawdown requests by a person knowledgeable of the cash management restrictions.
- f.* Inclusion of pertinent requirements in grantee's investment policy.
- g.* Depository agreement stipulating FDIC/FSLIC and segregation of account requirements.
- h.* Inclusion in requests for banking services of pertinent requirements.

**5. Relocation Assistance and Real Property Acquisition (Compliance Supplement)**

- a.* The existence of a policy statement compatible with federal regulations regarding relocation assistance and real property acquisition.
- b.* The existence of a "relocation officer," i.e., the assignment of a person to monitor compliance with federal requirements.

- c.* Proper training, copies of regulations and other procedures to ensure that persons responsible for administering programs involving relocation or real property acquisition are made aware of federal requirements.
- d.* Utilization of a checklist of federal requirements by persons responsible for administering programs involving relocation or real property acquisition.
- e.* Practice of sending pamphlets to persons being relocated, informing them of their rights and the prescribed procedures.
- f.* Practice of requesting written acknowledgement of persons being relocated that the required procedures and rights were made available to them.
- g.* Existence of a review function over the acquisition of real property for compliance with federal requirements.

**6. Federal Financial Reports (Compliance Supplement)**

- a.* Tickler file to ensure reports (including grant closeout reports) are filed timely (preferably centralized).
- b.* Assignment of responsibility for preparing reports (perhaps included as a duty in the employee's job description).
- c.* Policy of requiring review and written approval of federal financial reports for accuracy and timeliness of submission.
- d.* Periodic documented reconciliations of federal financial reports to the general ledger (or to work sheets that are reconciled to the general ledger).

**7. Allowable Costs/Cost Principles (OMB Circular A-87)**

- a.* Review of expenditures by a person knowledgeable of the provisions of OMB Circular A-87.
- b.* Involvement in the grant application/budget process by a person knowledgeable of the provisions of OMB Circular A-87.
- c.* Utilization of a checklist denoting allowable, unallowable and possibly unallowable costs by persons authorizing and/or reviewing expenditures charged to grant programs.
- d.* Existence of written policies regarding expenditures eligible for federal reimbursements.
- e.* Utilization of a person knowledgeable of indirect cost principles for preparation of the plan.
- f.* Assignment of responsibility for reviewing indirect cost allocations to a person knowledgeable of the requirements.
- g.* Periodic documented reconciliation of costs accumulated in the indirect cost pool to the general ledger.



- h.* Utilization of an outside expert to prepare or periodically review the indirect cost allocation plan and/or adherence to the plan.

#### **8. Drug-Free Workplace Act**

- a.* Existence of drug-free workplace policy.
- b.* Designated compliance officer.
- c.* Tickler file to ensure grant certifications are filed timely for each grant.
- d.* Checklist or sign-off sheet to ensure policy is distributed to employees paid with federal funds.
- e.* Assignment of responsibility for reporting violations to the Federal government.

#### **9. Administrative Requirements (Common Rule)**

- a.* Interest earned on advances:
  - (1) Existence of cash log showing interest earned on advances.
  - (2) Assignment of responsibility to remit such interest to appropriate Federal Agency at least quarterly.
- b.* Period of availability of funds:
  - (1) Review of expenditures to ensure charges result from obligations of the funding period unless carry-over of unobligated balances is permitted.
  - (2) Assignment of responsibility to liquidate all obligations incurred under the award no later than 90 days after the end of the funding period.
  - (3) Tickler file to ensure liquidation of obligations and submission of annual Financial Status Report (SF 269).
- c.* Program income:
  - (1) Establishment of records to track program income (and costs to generate program income if Federal Agency authorizes netting of income and costs).
  - (2) Assign responsibility for ensuring that current program income is deducted from current allowable costs in determining federal drawdowns or reimbursements.
  - (3) When authorized by Federal Agencies, assign responsibility of ensuring program income is used only in authorized manner. For example:
    - program income is added to the total funds committed to the project; or
    - program income is used to meet cost sharing or matching requirements.

- (4) Establish a grant “Master Control” sheet that indicates how program income is to be used on each grant.
- d.* Real property:
  - (1) Maintenance of real property records, including sources of financing, percentage of federal ownership, cost, and other pertinent information.
  - (2) Periodic reviews made to ensure real property is used for the originally authorized purposes.
  - (3) Assign responsibility for obtaining disposition instructions for real property and disposing of real property no longer needed for the originally authorized purpose through:
    - Retention of title.
    - Sale of property.
    - Transfer of title.
- e.* Equipment:
  - (1) Existence of fixed asset inventory system, which include sources of financing for fixed assets, percentage of federal ownership, location cost, and other pertinent information.
  - (2) Documentation in fixed asset manual of federal requirements relating to frequency of conducting inventory (every two years), transfer, property utilization, property disposition, and accounting.
  - (3) Review of fixed asset purchases, maintenance, safe-guarding, transfers, and dispositions by a per-person knowledgeable of the requirements.
- f.* Supplies:
  - (1) Maintenance of inventory records of unused supplies.
  - (2) Establish a policy regarding unused and unneeded supplies and the requirement to compensate the awarding Agency for its share.
- g.* Subawards to debarred and suspended parties:
  - (1) Assign responsibility for ensuring that awards are not made to any debarred or suspended parties.
- h.* Procurement:
  - (1) Incorporation of federal procurement standards in grantee’s purchasing policy.
  - (2) Knowledge of procurement-related restrictions by persons involved in the review and award of contracts.
  - (3) Review of purchase requisition and/or purchase orders by persons knowledgeable of procurement requirements.

- i. Subgrants:
  - (1) Inclusion of a provision for compliance with the Common Rule in every subgrant.
  - (2) Inclusion of other significant provisions in every subgrant.
  - (3) Policy to make subgrantees aware of the regulations imposed on them.
- j. Revolving Fund repayments:
  - (1) Establish revolving fund records that include information necessary to track repayments.
  - (2) Establish policy to ensure repayments are made on a timely basis.

### **.280 B. Example of Specific Requirements**

#### **Major Program—Specific Compliance Requirements Community Development Block Grant**

Besides documenting and testing the internal administrative controls over the general compliance requirements, the internal administrative controls over program-specific requirements need to be documented and tested. The controls and control procedures may vary significantly among governments so the individual circumstances in a particular government need to be examined. This section provides an example of the types of questions that may be asked to provide information about internal administrative controls over specific program requirements.

#### **A. Types of services allowed or unallowed**

- 1. What control procedure does the entity have in place to ensure that activities funded by the program are for allowable purposes and meet one of the national objectives?
- 2. What control procedure does the entity have in place to ensure that not more than 20 percent of the total grant is expended for planning and administration?

#### **B. Eligibility**

The auditor is not expected to make tests for recipient eligibility.

#### **C. Matching, level of effort, and/or earmarking requirements**

There are no matching, level of effort, or earmarking requirements.

#### **D. Reporting requirements**

- 1. What control procedure does the entity use to ensure that the grantee performance report is fully completed and submitted within two months after the end of each program year?
- 2. What control procedures are in place to ensure other Federal reports required by the program are identified, fully completed and submitted on a timely basis?

#### **E. Special tests and provisions**

- 1. What control procedures exist to ensure that program funds are not obligated or expended before the receipt of HUD's approval of a Request for Release of Funds (RROF) and environmental certification?

2. How does the entity ensure that all projects requiring an environmental review receive one?
3. What procedures do you employ to ensure that income earned under this program, if any, is properly accounted for and utilized in accordance with federal laws and regulations?
4. Describe the accounting processing involved from initiating the transaction to its inclusion in the financial statements, including how the computer is used to process data.

This understanding involves knowledge of the ways in which transactions are valued, classified, recorded, and summarized in the journals and ledgers.

After gaining an understanding of the direct flow of accounting information from its origin through the processing system to its compilation in the general ledger, an understanding of the processing steps, including how transactions are valued, classified, recorded and summarized, and control points at each processing step needs to be obtained.

5. Describe the financial reporting process including the extent of client procedures to prepare significant accounting and disclosure estimates. Also, describe the way in which general ledger information is summarized to arrive at the amounts and disclosures reported in the financial statements.

## Appendix C

# *The Single Audit Act of 1984*

### Short Title; Purpose

Section 1. (a) This Act may be cited as the "Single Audit Act of 1984".

(b) It is the purpose of this Act—

- (1) to improve the financial management of State and local governments with respect to Federal financial assistance programs;
- (2) to establish uniform requirements for audits of Federal financial assistance provided to State and local governments;
- (3) to promote the efficient and effective use of audit resources; and
- (4) to ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as added by this Act).

### Amendment To Title 31, United States Code

Sec. 2(a) Subtitle V of title 31, United States Code, is amended by adding at the end thereof the following new chapter:

### Chapter 75—Requirements For Single Audits

"Sec.

"7501. Definitions.

"7502. Audit requirements; exemptions.

"7503. Relation to other audit requirements.

"7504. Cognizant agency responsibilities.

"7505. Regulations.

"7506. Monitoring responsibilities of the Comptroller General.

"7507. Effective date; report.

"§ 7501. Definitions

"As used in this chapter, the term—

"(1) 'cognizant agency' means a Federal agency which is assigned by the Director with the responsibility for implementing the requirements of this chapter with respect to a particular State or local government.

"(2) 'Comptroller General' means the Comptroller General of the United States.

"(3) 'Director' means the Director of the Office of Management and Budget

"(4) 'Federal financial assistance' means assistance provided by a Federal agency in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations, but does not include direct Federal cash assistance to individuals.

"(5) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5, United States Code

“(6) ‘generally accepted accounting principles’ has the meaning specified in the generally accepted government auditing standards.

“(7) ‘generally accepted government auditing standards’ means the standards for audit of governmental organizations, programs, activities, and functions, issued by the Comptroller General.

“(8) ‘independent auditor’ means—

“(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards, or

“(B) a public accountant who meets such independence standards.

“(9) ‘internal controls’ means the plan of organization and methods and procedures adopted by management to ensure that—

“(A) resource use is consistent with laws, regulations, and policies;

“(B) resources are safeguarded against waste, loss, and misuse; and

“(C) reliable data are obtained, maintained, and fairly disclosed in reports.

“(10) ‘Indian tribe’ means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

“(11) ‘local government’ means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

“(12) ‘major Federal assistance program’ means any program for which total expenditures of Federal financial assistance by the State or local government during the applicable year exceed—

“(A) \$20,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$7,000,000,000;

“(B) \$19,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$6,000,000,000 but are less than or equal to \$7,000,000,000;

“(C) \$16,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$5,000,000,000 but are less than or equal to \$6,000,000,000;

“(D) \$13,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$4,000,000,000 but are less than or equal to \$5,000,000,000;

“(E) \$10,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$3,000,000,000 but are less than or equal to \$4,000,000,000;

“(F) \$7,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$2,000,000,000 but are less than or equal to \$3,000,000,000;

“(G) \$4,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$1,000,000,000 but are less than or equal to \$2,000,000,000;

“(H) \$3,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$100,000,000 but are less than or equal to \$1,000,000,000; and

“(I) the larger of (i) \$300,000, or (ii) 3 percent of such total expenditures for all programs, in the case of a State or local government for which such total expenditures for all programs exceed \$100,000 but are less than or equal to \$100,000,000.

“(13) ‘public accountants’ means those individuals who meet the qualification standards included in generally accepted government auditing standards for personnel performing government audits.

“(14) ‘State’ means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe.

“(15) ‘subrecipient’ means any person or government department, agency, or establishment that receives Federal financial assistance through a State or local government, but does not include an individual that receives such assistance.

#### “§ 7502. Audit requirements; exemptions

“(a)(1)(A) Each State and local government which receives a total amount of Federal financial assistance equal to or in excess of \$100,000 in any fiscal year of such government shall have an audit made for such fiscal year in accordance with the requirements of this chapter and the requirements of the regulations prescribed pursuant to section 7505 of this title.

“(B) Each State and local government that receives a total amount of Federal financial assistance which is equal to or in excess of \$25,000 but less than \$100,000 in any fiscal year of such government shall—

“(i) have an audit made for such fiscal year in accordance with the requirements of this chapter and the requirements of the regulations prescribed pursuant to section 7505 of this title; or

“(ii) comply with any applicable requirements concerning financial or financial and compliance audits contained in Federal statutes and regulations governing programs under which such Federal financial assistance is provided to that government.

“(C) Each State and local government that receives a total amount of Federal financial assistance which is less than \$25,000 in any fiscal year of such government shall be exempt for such fiscal year from compliance with—

“(i) the audit requirements of this chapter; and

“(ii) any applicable requirements concerning financial or financial and compliance audits contained in Federal statutes and regulations governing programs under which such Federal financial assistance is provided to that government.

The provisions of clause (ii) of this subparagraph do not exempt a State or local government from compliance with any provision of a Federal statute or regulation that requires such government to maintain records concerning Federal financial assistance provided to such government or that permits a Federal agency or the Comptroller General access to such records.

“(2) For purposes of this section, a State or local government shall be considered to receive Federal financial assistance whether such assistance is received directly from a Federal agency or indirectly through another State or local government.

“(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

“(2) If a State or local government is required—

“(A) by constitution or statute, as in effect on the date of enactment of this chapter, or

“(B) by administrative rules, regulations, guidelines, standards, or policies, as in effect on such date,

to conduct its audits less frequently than annually, the cognizant agency for such government shall, upon request of such government, permit the government to conduct its audits pursuant to this chapter biennially, except as provided in paragraph (3). Such audits shall cover both years within the biennial period.

“(3) Any State or local government that is permitted, under clause (B) of paragraph (2), to conduct its audits pursuant to this chapter biennially by reason of the requirements of a rule, regulation, guideline, standard, or policy, shall, for any of its fiscal years beginning after December 31, 1986, conduct such audits annually unless such State or local government codifies a requirement for biennial audits in its constitution or statutes by January 1, 1987. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally accepted government auditing standards, except that, for the purposes of this chapter, such standards shall not be construed to require economy and efficiency audits, program results audits, or program evaluations.

“(d)(1) Each audit conducted pursuant to subsection (a) for any fiscal year shall cover the entire State or local government’s operations except that, at the option of such government—

“(A) such audit may, except as provided in paragraph (5), cover only each department, agency, or establishment which received, expended, or otherwise administered Federal financial assistance during such fiscal year; and

“(B) such audit may exclude public hospitals and public colleges and universities.



“(2) Each such audit shall encompass the entirety of the financial operations of such government or of such department, agency, or establishment, whichever is applicable, and shall determine and report whether—

“(A)(i) the financial statements of the government, department, agency, or establishment present fairly its financial position and the results of its financial operations in accordance with generally accepted accounting principles; and

“(ii) the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon the financial statements;

“(B) the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing Federal financial assistance programs in compliance with applicable laws and regulations; and

“(C) the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon each major Federal assistance program.

In complying with the requirements of subparagraph (C), the independent auditor shall select and test a representative number of transactions from each major Federal assistance program.

“(3) Transactions selected from Federal assistance programs, other than major Federal assistance programs, pursuant to the requirements of paragraphs (2)(A) and (2)(B) shall be tested for compliance with Federal laws and regulations that apply to such transactions. Any noncompliance found in such transactions by the independent auditor in making determinations required by this paragraph shall be reported.

“(4) The number of transactions selected and tested under paragraphs (2) and (3), the selection and testing of such transactions, and the determinations required by such paragraphs shall be based on the professional judgment of the independent auditor.

“(5) Each State or local government which, in any fiscal year of such government, receives directly from the Department of the Treasury a total of \$25,000 or more under chapter 67 of this title (relating to general revenue sharing) and which is required to conduct an audit pursuant to this chapter for such fiscal year shall not have the option provided by paragraph (1)(A) for such fiscal year.

“(6) A series of audits of individual departments, agencies, and establishments for the same fiscal year may be considered to be an audit for the purpose of this chapter.

“(e)(1) Each State and local government subject to the audit requirements of this chapter, which receives Federal financial assistance and provides \$25,000 or more of such assistance in any fiscal year to a subrecipient, shall—

“(A) if the subrecipient conducts an audit in accordance with the requirements of this chapter, review such audit and ensure that prompt and appropriate corrective action is taken on instances of material non-compliance with applicable laws and regulations with respect to Federal financial assistance provided to the subrecipient by the State or local government; or

“(B) if the subrecipient does not conduct an audit in accordance with the requirements of this chapter—

“(i) determine whether the expenditures of Federal financial assistance provided to the subrecipient by the State or local government are in accordance with applicable laws and regulations; and

“(ii) ensure that prompt and appropriate corrective action is taken on instances of material noncompliance with applicable laws and regulations with respect to Federal financial assistance provided to the subrecipient by the State or local government.

“(2) Each such State and local government shall require each subrecipient of Federal assistance through such government to permit, as a condition of receiving funds from such assistance, the independent auditor of the State or local government to have such access to the subrecipient's records and financial statements as may be necessary for the State or local government to comply with this chapter.

“(f) The report made on any audit conducted pursuant to this section shall, within thirty days after completion of such report, be transmitted to the appropriate Federal officials and made available by the State or local government for public inspection.

“(g) If an audit conducted pursuant to this section finds any material noncompliance with applicable laws and regulations by, or material weakness in the internal controls of, the State or local government with respect to the matters described in subsection (d)(2), the State or local government shall submit to appropriate Federal officials a plan for corrective action to eliminate such material noncompliance or weakness or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(b) of this title.

#### “§ 7503. Relation to other audit requirements

“(a) An audit conducted in accordance with this chapter shall be in lieu of any financial or financial and compliance audit of an individual Federal assistance program which a State or local government is required to conduct under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal law or regulation, a Federal agency shall rely upon and use that information and plan and conduct its own audits accordingly in order to avoid a duplication of effort.

“(b) Notwithstanding subsection (a), a Federal agency shall conduct any additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any State or local government (or subrecipient thereof) to constrain, in any manner, such agency from carrying out such additional audits.

“(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or enter into contracts for the conduct of, audits and evaluations of Federal financial assistance programs, nor limit the authority of any Federal agency Inspector General or other Federal audit official.

“(d) Subsection (a) shall apply to a State or local government which conducts an audit in accordance with this chapter even though it is not required by section 7502(a) to conduct such audit.

“(e) A Federal agency that performs or contracts for audits in addition to the audits conducted by recipients pursuant to this chapter shall, consistent with

other applicable law, arrange for funding the cost of such additional audits. Such additional audits include economy and efficiency audits, program results audits, and program evaluations.

“§ 7504. Cognizant agency responsibilities

“(a) The Director shall designate cognizant agencies for audits conducted pursuant to this chapter.

“(b) A cognizant agency shall—

“(1) ensure that audits are made in a timely manner and in accordance with the requirements of this chapter;

“(2) ensure that the audit reports and corrective action plans made pursuant to section 7502 of this title are transmitted to the appropriate Federal officials; and

“(3)(A) coordinate, to the extent practicable, audits done by or under contract with Federal agencies that are in addition to the audits conducted pursuant to this chapter; and (B) ensure that such additional audits build upon the audits conducted pursuant to this chapter.

“§ 7505. Regulations

“(a) The Director, after consultation with the Comptroller General and appropriate Federal, State, and local government officials, shall prescribe policies, procedures, and guidelines to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such policies, procedures, and guidelines.

“(b)(1) The policies, procedures, and guidelines prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to programs of Federal financial assistance for the cost of audits. Such criteria shall prohibit a State or local government which is required to conduct an audit pursuant to this chapter from charging to any such program (A) the cost of any financial or financial and compliance audit which is not conducted in accordance with this chapter, and (B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

“(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit (A) the ratio of (i) the total charges by a government to Federal financial assistance programs for the cost of audits performed pursuant to this chapter, to (ii) the total cost of such audits, to exceed (B) the ratio of (i) total Federal financial assistance expended by such government during the applicable fiscal year or years, to (ii) such government's total expenditures during such fiscal year or years.

“(c) Such policies, procedures, and guidelines shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

“§ 7506. Monitoring responsibilities of the Comptroller General

“The Comptroller General shall review provisions requiring financial or financial and compliance audits of recipients of Federal assistance that are contained in bills and resolutions reported by the committees of the Senate and

the House of Representatives. If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

“(1) the committee that reported such bill or resolution; and

“(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

“(B) the Committee on Government Operations of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

“§ 7507. Effective date; report

“(a) This chapter shall apply to any State or local government with respect to any of its fiscal years which begin after December 31, 1984.

“(b) The Director, on or before May 1, 1987, and annually thereafter, shall submit to each House of Congress a report on operations under this chapter. Each such report shall specifically identify each Federal agency or State or local government which is failing to comply with this chapter.”

(b) The provisions of this Act shall not diminish or otherwise affect the authority of the Tennessee Valley Authority to conduct its own audits of any matter involving funds disbursed by the Tennessee Valley Authority.

(c) The table of chapters for subtitle V of title 31, United States Code, is amended by inserting after the item relating to chapter 73 the following new item:

“75. Requirements for Single Audits . . . . . 7501”.

## Appendix D

# Questions and Answers on the Single Audit Process of OMB Circular A-128

*Executive Office of the President*

*Office of Management and Budget*

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### Questions About Audit Requirements

**1. The Single Audit Act and Circular A-128 seem to have the same objectives as Attachment P to Circular A-102, "Uniform Requirements for Grants to State and Local Governments." Why was it necessary to replace an administrative policy already in place?**

The Congress found that the pace of the implementation of Attachment P was slow and difficult. There also appeared to be some disagreement between Federal, State and local officials in the scope and purpose of the single audit. The Single Audit Act strengthens the single audit requirement and clarifies what is expected as a minimum from an audit of Federal programs. Also, the Act calls for more frequent audits and covers programs that were not covered under Attachment P.

**2. Has OMB granted any exceptions to the requirements of Circular A-128?**

Yes. See Question 39.

**3. Must the auditor actually evaluate internal controls or can the report be based simply on the results of the auditor's testing of transactions from Federal programs?**

The auditor must evaluate internal controls. The Government Operations Committee's report accompanying the Act (House Report 98-708) states that "a single audit must include an evaluation and written report on the recipient's internal accounting and administrative control systems over its Federal financial assistance programs." The report makes it clear that while the auditors need not express an opinion on the recipient's internal controls, their report is to be the result of a study and evaluation of those controls and not merely the

by-product of testing for compliance with applicable laws and regulations. Further guidance on testing is contained in the AICPA Accounting and Audit Guide, for "Audits of State and Local Governmental Units"—1986 revised edition.

**4. If an audit is performed on a departmental basis rather than on a governmentwide basis, should a major program be determined based on the expenditures of the department or the expenditures of the government as a whole?**

If the entity is a department, the expenditures of the department would be the criteria used to determine a major program. For determining a major program the auditor should apply the criteria contained in Attachment A of Circular A-128 of the expenditures of the audited entity.

**5. Do State laws that authorize but do not compel a less frequent than annual audit requirement provide an adequate basis for the biennial exception?**

A State law that authorizes, but does not compel, a "less frequent than annual" audit requirement is not an adequate basis for qualifying for the biennial exception. Circular A-128 subsection 9(b)(2) provides that the exception applies only if the "less frequent than annual" audit requirement "is required" by statute. States with permissive (rather than mandatory) statutes constitute a subset of cases falling within the subsection (b)(3) exception (since the selection of more than one year cycles will be made by policy decision). Therefore, they must have converted to mandatory statutes by January 1, 1987 in order to qualify for the biennial audit exception.

**6. Are medicaid funds paid by States to hospitals and other providers of services covered by the Single Audit Act?**

Medicaid funds paid by the Federal government to States are Federal assistance payments and are covered by the Single Audit Act. However, most medicaid arrangements between the States and providers are contracts for services and not Federal assistance; therefore, they would not be covered by the Act.

**7. If an entity participates in a loan or loan guarantee program which is determined to be major but has no expenditures during the period under audit (pursuant to the Single Audit Act and Circular A-128), what procedures, if any, are required of the auditor?**

The auditor should ensure that the entity is in compliance with the appropriate laws and regulations governing the program. For loan guarantee programs that do not have expenditures during a specific period, the auditor should perform procedures annually to determine that loan recipients are eligible beneficiaries, the necessary review and award procedures are performed relative to loans, and that loans are being repaid and properly serviced. (See question 33.)

**8. What is the basis for defining "receives" Federal financial assistance?**

The definition of receipt of Federal assistance will be based on how the recipient recognizes and reports its revenue. Generally this means an entity has "received" Federal financial assistance when it has obtained Federal cash, or it has incurred expenditures which will be reimbursed under a Federal finan-

cial assistance program. For governments following GAAP receipt of Federal financial assistance means when the related assets or revenues are recorded in the financial statements. For those not following GAAP, receipt means when the cash is actually received.

For programs that involve the receipt of tangible assets (such as food stamps, food commodities and donated surplus property) “receives” should be based on when the revenue is recognized in accordance with GAAP.

For programs that do not involve the transfer of tangible assets (such as guarantee and insurance programs), “receives” shall be based on the transaction or event which gives rise to the award of assistance. For example, “receipt” of a loan guarantee would occur when a loan is made that is guaranteed by the Federal government. Or for example, “receipt” under an insurance program would occur when the event occurred that is insured by the Federal government. (See question 33.)

**9. Are all Indian organizations receiving Federal financial assistance required to comply with the Single Audit Act and OMB Circular A-128?**

All Federally recognized Indian tribes receiving \$100,000 or more in total Federal financial assistance are required to have a single audit performed of their operations. Tribes receiving between \$25,000 and \$100,000 must have a single audit or an audit of the Federal programs in which they participate. The Federally recognized tribes are those identified by the Bureau of Indian Affairs (BIA), U.S. Department of the Interior, as eligible to receive services for BIA. A list of these tribes is published periodically by BIA in the Federal Register.

The Circular also requires any other Indian organization, Alaskan Native Village or Regional Corporation that receives financial assistance under the Indian Self Determination Act, Public Law 98-638, to have a single audit performed, provided that they meet the criteria contained in Circular A-128.

**Questions on Compliance**

**10. When testing the entity’s compliance with Federal laws and regulations, can the auditors limit their audit procedures or inquiries to those specified in the Compliance Supplement?**

Yes. For the programs contained in the Compliance Supplement the audit of the requirements contained in the supplement will meet the requirements of Circular A-128.

**11. What should the test procedure be for programs not included in the Compliance Supplement?**

For programs not included in the Compliance Supplement, the auditor should review the award, grant agreement, contract, regulations, or enabling legislation to determine whether there are special conditions that need to be considered. Also, the auditor may have to contact the Federal program agency or the cognizant agency for assistance.

**12. Is the auditor required to make compliance tests of nonmajor programs?**

Yes. The Circular requires that transactions that are selected in connection with examinations of financial statements and/or evaluations of internal controls shall be tested for compliance with Federal laws and regulations that apply to such transactions.

**13. Are auditors required to review the program compliance requirements contained in the Compliance Supplement?**

For major and/or nonmajor programs the use of the Compliance Supplement is not mandatory. However, the Federal Government recommends its use for identifying the compliance requirements to be tested. The requirements contained in the Compliance Supplement are those that Federal program officials and the Inspectors General have identified as being the minimum requirement for their programs. Auditors should recognize the importance of the Compliance Supplement to the Federal agencies when exercising their professional judgment in identifying which laws and regulations may have a material effect on the programs.

**14. If an auditor selects a Federal assistance program transaction in his tests of financial balances or internal controls is the auditor required to test the entity's compliance with all major compliance requirements of that program?**

No. The auditor would be required to test only those compliance aspects of the particular transaction selected. For example, if the transaction is a charge for travel the auditor should ascertain whether the travel was necessary and authorized by the grant or contract agreement.

**15. Must the auditor read each Federal assistance agreement in its entirety?**

No. The auditor should be familiar with the special terms and conditions of grants, loans, etc., but is not required to read each agreement in its entirety.

**16. Does OMB Circular A-128 replace the guidance on the audit of block grant programs?**

Yes.

**17. Should the recipient's cost allocation plan be reviewed?**

If indirect costs were claimed as expenditures on Federal programs during the period being audited, the auditor should ascertain if amounts claimed or used for matching were determined in accordance with OMB Circular A-87, "Cost Principles for State and Local Governments."

The auditor should do enough work to determine the reasonableness of the indirect cost rate or rates. In order to determine this the auditor should determine whether:

- The costs, bases, and methods of allocating costs are in accordance with guidelines provided in OMB Circular A-87 or a plan that has been approved by the Federal Government.
- The same costs are not treated or charged both as indirect costs and direct costs.
- Statistical data such as square footage, population, salaries, included in the bases are current and reasonable.
- The costs are reasonable in amount and they are properly allocated.
- The costs were incurred within the period under review.

**18. Must the expenditures of each major Federal program be considered as a separate population to support an auditor's report as to whether the entity has complied with laws and regulations that may have a material effect upon each major Federal assistance program?**

Both the Single Audit Act and Circular A-128 clearly indicate the auditor must determine and report on compliance for each major program. Both also



indicate the auditors shall select and test a representative number of transactions from each major program. Audit efficiency might be achieved by developing a test of transactions based on the overall population of all major (and even nonmajor) program transactions. However, the selection and testing of transactions must include, based on the auditor's professional judgment, a representative number of transactions from each major program.

### **Questions on Audit Sampling**

#### **19. Are independent auditors required to use statistical sampling techniques?**

Either a nonstatistical or statistical approach to audit sampling may be used. However, statistical sampling is the preferred approach for selecting transactions for audit whenever the universe to be audited is susceptible to statistical treatment and the use of the technique is economical. The auditor is not required to *report* projected questioned costs, but in forming a basis for his opinion on an entity's compliance with requirements governing each major Federal financial assistance program, the auditor should project the results of any sampling applications he performed to the population from which he selected the sample. However, as indicated in answer 32, the size of the universe, the number tested, the error rate (and related amounts when applicable) should be disclosed in the auditor's report, in order to give the reader a basis for judging the prevalence of noncompliance.

#### **20. When testing for compliance with laws and regulations using a sampling technique, should the auditor expand the scope of the audit to determine the effect of any questioned costs?**

The scope of the audit is not required to be expanded nor is the auditor required to include a projection of questioned costs to the universe of Federal financial assistance programs. However, the auditor must consider the potential effect of the questioned costs in reporting on the entity's financial statements and on individual financial assistance programs.

### **Questions About Subrecipient and Contractor Audits**

#### **21. How are subrecipients defined in the Single Audit Act?**

Under OMB Circular A-128(5) Subsection (m), subrecipients are defined as "any person or government department, agency or establishment that receives Federal financial assistance to carry out a program through a State or local government, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a direct recipient of Federal financial assistance."

#### **22. What is the difference between a subrecipient and a vendor and what is the determining factor in deciding whether a subrecipient relationship exists?**

A subrecipient is an entity that receives Federal assistance passed down from the prime recipient. The subrecipient's responsibility is to help the recipient meet the requirements of the assistance award. A subrecipient's performance would be measured against meeting the objectives of the Federal assistance award. (See questions 21 and 26.)

A vendor is an entity that receives a procurement contract for goods or services from a recipient which will be paid for from Federal assistance funds. The vendor's responsibility is to meet the requirements of the procurement contract.

The test for a subrecipient relationship is whether a subrecipient receives Federal financial assistance from a recipient to carry out a program. Where a recipient enters into a *procurement* contract to buy goods or services, the other party to the contract is not a subrecipient for purposes of single audit. The answer is the same regardless of the type of entity involved (governmental, nonprofit, etc.) or the form of the agreement between the parties.

**23. Are prime recipients to conduct quality control reviews of subrecipient audits?**

Circular A-128 does not specifically require recipients to make quality control reviews of subrecipient audits. However, prime recipients are expected to establish a system to assure that audits of the subrecipients meet the requirements of Circular A-128 (or A-110 "Uniform requirements for grants to universities, hospitals and other nonprofit organizations" when applicable). (See question 24.) Such a system should include a desk review of each subrecipient report to ensure it conforms to the Circular.

**24. Are nonprofit organizations and universities receiving funds through a State or local government required to have an audit made in accordance with the provisions of Circular A-128?**

No. The provisions of Circular A-128 apply only to State and local governments including public hospitals and public colleges and universities and to certain Indian Tribes. Audits of other nonprofit organizations should be made in accordance with the applicable statutory requirements and/or provisions of Circular A-110, "Uniform Requirements for Grants to Universities, Hospitals, and Other Nonprofit Organizations." State and local governments may exclude public hospitals and public colleges from the provisions of Circular A-128 provided that the audits are made in accordance with statutory requirements and the provisions of Circular A-110.

**25. For many Federal programs, funds flow down from the recipient to a subrecipient. Is the independent auditor required to make audits of subrecipients as part of the recipient audit?**

No. Circular A-128 requires the recipient to determine that subrecipients have an audit made in accordance with the Circular's requirements. As long as the audit report of the subrecipient is current, it need not cover the same period as the recipient's audit. It is the recipient's responsibility to:

- a. establish a system to assure that the audits of the subrecipients meet the requirements of Circulars A-128 or A-110.
- b. establish a system for followup on questioned costs, weaknesses in internal control systems, and other audit exceptions and ensure that appropriate corrective action is taken within 6 months.
- c. consider whether the subrecipient's records necessitate adjustments of the recipient's own records.
- d. require access to the subrecipient's records and financial statements.

The recipient's auditor would:

- a. review the recipient's systems for obtaining and acting on subrecipient audit reports.
- b. test to determine whether the system is functioning in accordance with prescribed procedures.

- c. comment on the recipient's monitoring and disbursing procedure with respect to subrecipient, if warranted by the circumstances. Reported questioned costs require consideration for materiality, possible adjustment of financial statements, and possible footnote disclosure.

In the event that subrecipient audits have not been made and the amount of funds are material, the scope of the recipient audit can be expanded to include testing of the subrecipient expenditures. Alternatively, the recipient's auditor should report this condition as a finding and if the subrecipient expenditures are material to the recipient, then the recipient's auditor should consider whether to qualify and/or disclaim in their audit report in financial statements because the subrecipient's expenditures were not tested.

If a subrecipient's audit report was due but not received the recipient's auditor should report this condition as a finding.

**26. Does the requirement for a single audit apply to contracts awarded by recipients to profitmaking organizations, and private or governmental organizations?**

Commercial contractors (private for profit) and private or governmental organizations providing goods or services to State or local governments are not required to have a single audit performed in accordance with Circular A-128. State and local governments should use the same procedures used to monitor their own expenditures to ensure that the contractor has complied with laws and regulations affecting the expenditure of Federal funds. However, the use of a contract by a governmental recipient to provide Federal *financial assistance* to a subrecipient will require the subrecipient to have an audit made in accordance with the Act.

**27. Who is responsible for the audit resolution of findings resulting from subrecipient audits?**

The entity providing funds to the subrecipient is responsible for resolving findings pertaining to pass through funds resulting from the audit. Consequently, in some cases an entity may first have to resolve some audit findings with a Federal agency and then other findings with another level of government for funds which flow down from a recipient to a subrecipient.

**28. Auditors at the subrecipient level have found that the subrecipient is not always able to identify the Federal share of funds received from another governmental entity. What are the auditor's responsibilities when he finds such a situation?**

It is the subrecipient's, not the auditors' responsibility to learn or determine the amount, if any, of Federal funds included in monies received from a recipient government. If a government is not able to determine the portion of Federal funds included in the monies received, the auditor at a minimum should review the award document and determine whether the terms and conditions of the award are being met for all funds. The auditor should comment in the audit report that Federal funds could not be identified in pass-through awards and recommend that recipients identify the amount of Federal funds in subawards.

**29. Can a recipient also mandate a single audit on its nonprofit subrecipients who also receive direct Federal funding subject to the A-110 audit requirement?**

Yes. A State and local government may have its own audit requirements including A-128 audits for subrecipients provided the audit covers as a mini-

mum the Federal requirements. The Federal audit requirements for State and local governments appear in Circular A-128, "Audits of State and Local Governments." Federal audit requirements for other not-for-profit recipients are covered in Attachment F "Standards for Financial Management Systems" to Circular A-110, "Uniform Requirements for Grants to Universities, Hospitals, and Other Nonprofit Organizations."

**30. What are the audit requirements under the Single Audit Act for profit making organizations, such as nursing homes and individuals, receiving Federal financial assistance through State and local governments?**

The Single Audit Act contains no audit requirements for profit making organizations or individuals. However, if a prime recipient passes down funds with the intent of providing financial assistance to a profit making subrecipient, the prime recipient has the same responsibilities outlined in paragraph 9 of Circular A-128. (See questions 6, 22, and 25.)

**Questions About Audit Reports**

**31. If a government elects to have a single audit performed on an individual department, agency or establishment, can only the schedule of Federal financial assistance and the related auditor's reports be submitted?**

No. The Act and Circular A-128 provide certain governments with the option to have a single audit of the entire operations of that government, or of only those departments, agencies or establishments that received, expended, or otherwise administered Federal financial assistance. If a single audit is performed for individual departments, agencies or establishments, then the audited financial statements with the auditor's report thereon, the schedule of Federal financial assistance with the auditor's report thereon, and the auditor's reports on internal controls and compliance shall all focus on the individual departments, agencies or establishments selected for inclusion in the Single Audit package. (See question 35 for further guidance.)

**32. Is it essential that findings of noncompliance with applicable laws and regulations include the cause and effect as well as the condition and criteria?**

Findings of noncompliance *must* address the condition—what is questioned—and the criteria as to what the condition should have been. It should also address cause and effect; however, in some cases this will be impossible and, in other cases, the benefit of the auditor extending his procedures to develop the cause and effect may not justify the additional audit costs. Auditors should place the findings in proper perspective to give readers a basis for judging the prevalence of noncompliance. The auditor should disclose the number and dollar amount of items tested, size of universe error rate and the number and dollar amount of findings. The General Accounting Office's *Standards for Audit of Governmental Organizations, Programs, Activities and Functions* provides guidance in presenting noncompliance findings.

**33. How should Federal guarantee, loan or insurance programs which are operated by the governmental entity, but do not involve a current Federal outlay, be included on the schedule of Federal domestic assistance and in determining the program's status as a major program?**

The existence and value of Federal guarantee, loan or insurance programs at the end of the fiscal year should be disclosed in a footnote to the schedule of

Federal assistance. Any interest subsidy, or administrative costs allowance received during the fiscal year under a loan or loan guarantee program should be included in the schedule of Federal assistance.

Generally, the total amount of expenditures of Federal Financial assistance included in the Schedule is the basis for applying the criteria in the attachment to A-128 for determining Major Federal Assistance Programs. However, for a loan or loan guarantee program the total value of new loans during the fiscal year plus the balance of loans for previous years for which the government is at risk and any interest subsidy, cash or administrative costs allowance received should be used to determine if that program is also a Major Federal Assistance Program. One exception to this is the Guaranteed Student Loan Program. Institutions of higher education that are not lenders should use the value of new loans made during the year.

If based on the above, it is determined that a loan or loan guarantee program is a Major program, this should not effect the identification of Major programs, using the criteria applicable to the Schedule of Federal Assistance. Sometimes, including a large loan program in the base used to determine major programs may distort the base. Therefore, if the number of programs determined to be major is significantly affected by the inclusion of a guarantee loan program in total Federal assistance the auditor should use his judgment as to whether the guarantee program should be included when determining which other programs are major.

**34. Where should audit reports be sent when the audit is completed?**

In accordance with the provision of Circular A-128 the recipient shall submit copies of reports to each Federal department or agency that directly provided Federal assistance funds to the recipient. Each agency may specify in its program regulations or in the award the distribution point for the Single Audit reports. Recipients of \$100,000 or more in Federal funds shall submit a copy of the audit report within 30 days after issuance to a central audit report clearinghouse. The address of the clearinghouse is: Bureau of the Census, Data Preparation Division, 1201 E 10th Street, Jeffersonville, Indiana 47132.

Subrecipients shall also submit copies to recipients that provided them with Federal assistance funds.

**35. Does the circular require the preparation of general purpose financial statements in accordance with generally accepted accounting principles?**

The Circular does not require the preparation of general purpose financial statements in accordance with GAAP. However, financial statements are required. The Circular requires an audit of financial statements that are prepared by the recipient to meet its needs and the needs of other statement users. However, if these statements are not prepared in accordance with generally accepted accounting principles, the audit report should state the nature of the variances therefrom and follow professional guidance for reporting on financial statements which have not been prepared in accordance with GAAP.

**36. Circular A-128 calls for the auditor to comment in the compliance report on financial reports and claims for advances or reimbursements made to the Federal Government. Does this mean that a 100 percent audit of all such reports and claims must be made?**

No. A determination as to the reliability of the Federal financial reports can be made through a study and evaluation of internal systems used to accumulate the data for the reports in addition to tests of sample reports.

**37. Can a cognizant agency reject an audit report or take similar actions? If so, what steps will be taken?**

Circular A-128 anticipates that a Federal cognizant agency will advise the recipients of audits that have been found not to have met the requirements. In such instances, the recipient will be expected to work with the auditor to take corrective action. If corrective action is not taken, the Federal cognizant agency shall notify the recipient organization and Federal awarding agencies that the audit failed to meet Federal standards and cannot be relied upon. The Circular requires that the cognizant agency recommend followup action. This may include a recommendation to other Federal agencies to return the audit report to the recipient. It may also include a recommendation regarding appropriate sanctions by the Federal awarding agencies that should be taken against the recipient organization.

**38. If a State makes an award of \$100,000 to a city and 50 percent of the award comes from Federal sources how much should be reported in the city's schedule of Federal financial assistance?**

The city's schedule of Federal Financial Assistance should show the amount of the Federal funds for each Federal assistance program. In this case the amount would be \$50,000. If the percentage or amount of the Federal share is not known the total amount should be included with a footnote.

**39. If a college or university is covered as part of the single audit of the State, must the statement of Federal financial assistance list all of the individual grant and contract awards by catalog of Federal domestic assistance program number?**

No. In some cases because of the large number of awards or the lack of data it may be impractical to list them all. A summary of total expenditures by funding agency and a schedule of expenditures for each student financial assistance program will suffice for now. Reporting guidance for university audit reports will be forthcoming soon as part of a new revised OMB Circular A-88, "Coordinating Audits and Negotiating Indirect Cost Rates at Educational Institutions."

**40. How should the value of food stamps and commodities distributed and inventory thereof be reported?**

The value of food stamps issued and commodities distributed should be shown on the schedule of Federal assistance either as an expenditure or in a note. Likewise the value of food coupons on hand and the value of commodities in inventory should be shown in the entity's financial statements or in a note.

**Questions About Cost and Reimbursement for Audits**

**41. How will State and local governments pay for the cost of the single audits?**

State and local governments should use normal financing procedures to pay for the single audit, the cost of which should be less than the aggregate cost of numerous individual Federal assistance audits. Under the current arrangements, the Federal Government will reimburse recipients for its fair share of audit costs in accordance with Circular A-87, "Cost Principles for State and Local Governments." These payments are usually made as part of the allocated cost of Federal assistance programs being carried on by the unit of government. However, Circular A-128 provides the allowable charges for audit may also be a direct cost.

**Question About Sanctions****42. If recipients do not comply with the provisions of Circular A-128, what happens?**

The Single Audit Act provides that no cost may be charged to Federal assistance programs for audits required by the act that were not made in accordance with the Circular. We expect that this sanction will be enforced much more frequently than it has in the past. Therefore, State and local officials should ensure that there is an adequate contract administration system in effect to monitor contracts for audit servicing.

In cases of a grantee's continued inability or unwillingness to have a proper audit, Federal agencies have other sanctions available including:

- withholding a percentage of assistance payments until the audit is completed satisfactorily, and/or
- suspending the Federal assistance agreement until the audit is made.

Federal agencies may take action to perform the necessary audit work themselves.

**Questions on Cognizant Responsibility****43. What guidance is provided to the cognizant audit agencies regarding their responsibilities in an organization-wide audit?**

The responsibilities of the cognizant audit agencies are set forth in a document entitled, "Federal Cognizant Agency Audit Organization Guidelines." The document was prepared by the President's Council on Integrity and Efficiency Single Audit Committee.

It addresses such areas as:

- technical advice and liaison,
- desk review of audit reports,
- reviews of audit organizations and their work,
- addressing deficiencies noted during reviews, and
- processing audit reports by Federal agencies.

The "Federal Cognizant Agency Audit Organization Guidelines" can be obtained from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402. Stock Number 040-000-00491-2.

**44. What is the role of the cognizant audit agency regarding the approval of the audit scope or plan?**

There is no requirement for the Federal cognizant audit agency to approve the audit scope or plan in advance of the audit. However, most auditors and cognizant audit agencies would agree that a review of the plan is highly useful for avoiding future misunderstandings.

**45. When a recipient contracts for a single audit, does the Federal cognizant agency need to approve the auditor in advance?**

No. The selection of an independent auditor is a recipient responsibility and the process is often addressed in State law. Prior approval is not required by the Federal cognizant agency, although the Federal cognizant audit agency can provide advice for those recipients that have little or no experience in arranging for audit service.

Recipients selecting independent auditors should follow the Procurement Standards contained in Attachment O of OMB Circular A-102, "Uniform Requirements for Grants to State and Local Governments." These standards

provide that services shall be obtained in an efficient and economical manner that provides maximum open and free competition. In addition recipients should ensure that the selected auditors are not currently in a suspended or debarred status. (Federal agencies are in the process of developing regulations which will explain procedures for screening of debarred and suspended organizations. Final regulations will be issued early in calendar year 1988.)

**46. Is Attachment O "Procurement Standards" applicable to the procurement of single audit services if the audit costs are not charged to Federal programs?**

Yes. Even though the Federal Government is not being charged for audit services and procurement standards should be followed. The standards help ensure that the auditor selected will meet the general standards for auditors contained in the GAO publication "Standards For Audit of Governmental Organizations, Programs, Activities, and Functions."

**47. OMB issued a listing of Federal agencies responsible for cost negotiation and audits of the larger State and local governments on January 6, 1986. How do local governments not included in the listing get technical advice and guidance?**

Cognizant agencies will not be assigned to those governments not included in the listing. Smaller governments not assigned a cognizant agency that need technical audit advice or guidance should contact the Federal agency or State agency that provides them the most funds whether the funds are transferred directly or indirectly. Circular A-128 refers to these Federal agencies as general oversight agencies.

**48. Does an oversight agency have the same responsibility as a cognizant agency?**

No. An oversight agency's responsibility would not be nearly as broad as a cognizant agency's responsibilities. Like a cognizant agency, an oversight agency would represent all Federal agencies. However, an oversight agency's primary responsibility would be to provide advice and counsel to recipients when requested by the recipient. An oversight agency may take on additional responsibilities if deemed necessary, such as ensuring audits are conducted and transmitted to appropriate Federal officials, conducting reviews of reports and audit work and resolving crosscutting or systems findings.

**Questions About Small and Minority Audit Firms**

**49. What are the obligations of recipients of Federal funds under OMB Circular A-128 for hiring small and minority audit firms?**

Paragraph 19 requires recipients of Federal funds to provide the maximum practicable opportunity for small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals to be considered for selection by audited organizations. Audited organizations must provide such opportunity in order to ensure that qualified audit firms are not overlooked merely because they may be small or controlled by disadvantaged persons.

State and local governments and other recipients of Federal funds retain the authority to select audit firms at their discretion. Federal cognizant audit agencies do not have the authority under Paragraph 19 to challenge an audited organization's choice of audit firms. Paragraph 19 establishes a requirement of a fair and open process for selection of audit firms; it does not establish any requirement that particular firms or classes of firms be selected.



**Questions About Other Matters****50. Will changes be made to the audit requirements contained in the compliance supplement and Circular A-128?**

Yes. When the need for change is disclosed from our own experience or is brought to our attention by others, the Director of OMB will make such changes or interpretations as necessary. When important changes are proposed, the Director of OMB will solicit the views of Federal agencies, State and local officials, professional organizations, public interest groups, and other interested parties. He will use these suggestions in interpreting or revising the requirements.

**51. Can Federal agencies add requirements to those prescribed by Circular A-128?**

No additional audit requirements should be imposed upon recipients unless specifically required by Federal law, executive order or prior arrangement as stated in paragraph 10 of A-128. To the extent that problems are encountered between a grantee and a Federal grantor agency which cannot be resolved, the Office of Management and Budget will lend assistance to resolve such problems in a timely manner.

**52. When is a single audit report due?**

A single audit report is due 13 months following the end of the entity's fiscal year. The twelve months are for the preparation of the audit report. The 13th month is for audit transmittal.

**53. Are funds provided by the National Guard bureaus to the States covered by the Single Audit Act?**

At the present time, funds provided by the National Guard Bureau to the States are not considered Federal financial assistance funds within the provisions of the Single Audit Act. However, the matter is currently under review.

## Appendix E

### ***OMB Circulars That Address Management of Federal Assistance Programs Applicable to State and Local Governments***

(This appendix presents a synopsis of certain OMB circulars. OMB Circular A-128 is included in its entirety.)

**E.1** The U.S. Office of Management and Budget (OMB), in consultation with federal grantor agencies, the General Accounting Office (GAO), and representatives of recipient governments, has developed a series of financial circulars that provide guidance to be observed by all federal executive branch agencies in imposing financial and other administrative requirements on recipients of federal assistance. Two of these circulars, A-87 and A-102, which are applicable to state and local governments, are summarized below.

### **OMB Circular A-87 Cost Principles Applicable to Grants and Contracts**

#### **What Is Circular A-87?**

**E.2** Circular A-87 establishes principles for determining the allowable costs incurred by state, local, and federally-recognized Indian tribal governments under grants, cost reimbursement contracts, and other agreements with the federal government and sets forth the procedures to recover them. The basic intent underlying the circular is that federally assisted programs should bear their fair share of costs. The circular also provides that one federal agency will negotiate grantees' indirect costs on behalf of all other federal agencies.<sup>1</sup>

#### **Allowable Costs**

**E.3** Generally, costs must be necessary, reasonable, and directly related to the grant. In addition, they must be legal, proper, and consistent with the policies that govern the recipient's own expenditures. Any credits, such as purchase discounts, price adjustments, and federal funds available from other sources, must be deducted from total costs.

#### **Composition of Cost**

**E.4** Costs applicable to a grant program may be direct or indirect. There is no universal rule for classifying certain costs as either direct or indirect. In most cases, the accounting system used by the recipient will specify which types of costs are direct and which are indirect. The important point is that recipients treat costs consistently for all grant programs.

**E.5** Direct costs should be specifically identifiable to the grant. Typical examples are employee compensation, materials, equipment, and travel expenses incurred specifically to carry out the award.

**E.6** Indirect costs are those incurred for common or joint purposes that benefit more than one cost objective and cannot be readily identified with a

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<sup>1</sup> Generally referred to as federal cognizant agency for indirect costs.

particular cost objective without effort disproportionate to the results achieved. These costs should be allocated so that each activity bears its fair share of total indirect costs. To do this, a recipient should develop an indirect cost allocation plan. The plan, which incorporates a methodology for determining allowable indirect costs, results in the determination of an indirect cost rate. This rate is applied to a direct cost base to determine the amount of indirect costs allowable to an activity. When indirect cost rates cannot be readily determined, recipients may negotiate a fixed amount to be used as a substitute. In some cases, indirect costs are limited by legislation.<sup>2</sup> Any excess indirect cost caused by such limitations may not be shifted to other grants.

### **Cost Allocation Plan**

**E.7** In order to recover indirect costs, the recipient must develop a cost allocation plan that provides the basis for the indirect cost rate. To be acceptable, the plan must consider all indirect costs of the department administering the grant and other agencies' costs that will be charged against the grant.<sup>3</sup> The plan should (a) describe the services provided and explain their relevance to the grant programs, (b) list the expenses to be charged to the grants, and (c) explain the method used to distribute costs.

**E.8** The Department of Health and Human Services with OMB approval has issued instructions to state and local governments for the preparation of cost allocation plans. State agencies and departments must have their plans approved before indirect costs can be recovered. Local governments and departments need not submit plans for approval unless requested to by the agency responsible for reviewing their plans. However, they must retain their plans, in case of a subsequent audit.

### **Cognizant Agency List**

**E.9** All federal programs incur direct and indirect costs as part of their ongoing operations. In order to spread the administrative load of plan review and approval, the OMB publishes a list of cognizant agencies and the organizations whose plans they are responsible for reviewing.

## **OMB Circular A-102 Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments**

### **What is Circular A-102?**

**E.10** Circular A-102 establishes uniform financial and other administrative requirements for grants to state and local governments. It promotes uniformity and consistency among federal agencies in their administration of grants. It establishes uniform requirements in sixteen areas. Only those specific requirements imposed by legislation establishing a grant program can take precedence over A-102.

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<sup>2</sup> The auditor should be aware that federal grants may be subject to laws that limit the amount of indirect costs that may be allowed. Agencies that sponsor grants of this type will establish procedures which will assure that the amount actually allowed for indirect costs under each such grant does not exceed the maximum allowable under the statutory limitation or the amount otherwise allowable under the Circular, whichever is the smaller.

<sup>3</sup> For states and larger cities, there are usually two allocation plans, one for centralized services and one at the department or agency level.

The following is a summary of specific attachments of the circular.

## Attachment

- A. *Cash depositories.* State and local governments can use their regular banking procedures, without any requirements for separate bank accounts, or special bank eligibility procedures. Use of minority banks is encouraged.
- B. *Bonding and insurance.* Except as otherwise required by law, recipients can use normal bonding and insurance procedures for contracts of \$100,000 or less. If the agency is certain that the government's interests are adequately protected, the recipient's procedures may be used for contracts larger than \$100,000. If that is not the case, construction contracts over \$100,000 must have a 5-percent bid guarantee, a 100-percent performance bond, and a 100-percent payment bond. No other federal requirements in this area should be imposed.
- C. *Records retention.* Recipients may follow their own practices as long as they retain records for three years, in order to allow access for audit and public examination. If audit findings are not resolved, the records shall be retained beyond three years. The retention period starts when the annual or final expenditure report has been submitted or, for non-expendable property, from the date of final disposition.
- D. *Waiver of single state agency requirements.* When requested by a state, federal agencies should waive or remove single state agency requirements. Such requirements set up impediments to effective administration. Future legislation should avoid single state agency requirements if possible.
- E. *Program income.* Program income means gross income earned by the recipient entity from grant-supported activities. Interest earned on advances of federal funds shall be remitted to the federal agency except for interest earned on advances to states and instrumentalities of a state. Other income attributable to the grant should be used to increase the scope of the project. Program income must be deducted from the total project cost to determine the amount in which the federal government will share, or it must be applied toward the matching share (with federal agency permission).<sup>4</sup>
- F. *Matching share.* Standards are established for determining the matching contribution. It can consist of charges that are project costs, including cash and "in-kind" contributions. In-kind contributions must be necessary and reasonable, identifiable from the grantee's records, properly valued, and not claimed for any other federal program. Specific guidelines are set forth calculating the value of in-kind services provided by volunteers and contributions of materials, equipment, buildings, land, and space.
- G. *Standards for grantees' financial management systems.* Standards are prescribed for financial management systems used for grant-supported activities. Federal agencies will not impose requirements other than for current, accurate, and complete disclosure of financial

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<sup>4</sup> The federal agency making the award determines which method of using grant program income will be followed.

results; adequate identification of source and application of funds; effective control and accountability for funds and property; comparison of actual and budgeted amounts; minimizing time elapsing between receipt and expenditure of funds; a cost allocation plan; and overall organization audits performed at the direction of the grantee.

- H. *Financial reporting requirements.* Four standard reporting forms are provided to replace the different forms previously required for each grant program.
1. *Financial status report*—To report status of funds for all non-construction programs.
  2. *Federal cash transactions*—To monitor cash balances when funds are advanced to grantees by letter of credit or Treasury checks.
  3. *Request for advance or reimbursement*—For all nonconstruction programs when advance letter of credit or predetermined advance payments are not used. May be submitted monthly.
  4. *Outlay report and request for reimbursement*—For reimbursement on all construction programs. May be submitted monthly.
- I. *Monitoring and reporting program performance.* Recipients will be held responsible for monitoring programs to assure that time schedules are met and that performance goals are achieved. Periodic reports of progress, documented with quantitative data when possible, will be required.<sup>5</sup> If goals are not met, or costs are exceeding budget, these conditions must be reported. Between reporting dates, grantees must report any unusual conditions or events that will affect achieving goals within the time period specified.
- J. *Grant payment requirement.* A letter of credit will be used for all grants, except construction grants, for which it is optional, when there is a continued relationship of at least twelve months, when the payment for a year would exceed \$120,000, and when the recipient's financial management system meets federal standards. Funds will be advanced when the annual amount is less than \$120,000.<sup>6</sup> Reimbursement will be used when there is not an adequate financial management system.
- K. *Budget revision procedures.* For nonconstruction grants, prior federal approval for budget revision must be obtained for the following reasons:
1. There is a change in the program's scope or objective or a need for additional federal funding.
  2. The cumulative amount of transfers among object class categories or among programs, functions, or activities exceeds 5 percent or \$100,000.<sup>7</sup>
  3. Indirect cost amounts are to be used for direct costs (if required by the federal agency) or if the budget revision contains items requiring A-87 approval.
  4. Recipients plan to transfer funds allocated for training to other categories of expenses.

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<sup>5</sup> These reports are submitted together with the financial status reports.

<sup>6</sup> By Treasury check.

<sup>7</sup> This occurs only when required by the federal grantor agency.

Construction grants need approval for revisions only in the case of (1). When federal funds are expected to exceed needs by more than 5 percent or \$5,000, the federal agency must be notified.

- L. *Grant closeout procedures.* Federal agencies must establish closeout procedures that provide for prompt payments by the grantor or prompt refunds by the grantee, reports within ninety days of completion, adjustment of the federal share, accounting for government property, and retaining the right of recovery until final audit. Federal agencies must also develop procedures to be followed when the grantee does not comply with the grant agreement and the grant is terminated.
- M. *Standard forms for applying for federal assistance.* With one exception, all state, local, and Indian tribal governments applying for federal grants will use the forms outlined in this attachment. Most formula grants do not require grantees to apply for assistance on a project basis. Hence, these programs are not required to use the forms.
- N. *Property management system.* Standards governing the use and disposition of federally financed property are prescribed. The grantee's property management procedures must provide for accurate records, biannual inventories, adequate maintenance and control, and proper sales procedures. Each federal agency must prescribe requirements covering real property for grantees. Such requirements will cover, at a minimum, the following:
  - 1. Vesting title
  - 2. Use of property in other projects
  - 3. Disposition after use

In general, after using the property, the grantee will request disposition instructions from the federal agency. The federal agency shall observe the following rules: The grantee may compensate the government and retain title, sell the property and pay the government, or transfer title for the property back to the government.<sup>8</sup>

- O. *Procurement standards.* The attachment outlines four methods for making procurements under the terms and conditions of grants.
  - 1. Small purchase procedures
  - 2. Competitive sealed bids (formal advertising)
  - 3. Competitive negotiation
  - 4. Noncompetitive negotiation

## OMB Circular No. A-128

April 12, 1985

### TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Audits of State and Local Governments.

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502. It establishes audit requirements for State and Local gov-

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<sup>8</sup> Similar requirements are provided in detail for personal property.

ernments that receive Federal aid, and defines Federal responsibilities for implementing and monitoring those requirements.

2. *Supersession.* The Circular supersedes Attachment P, "Audit Requirements," of Circular A-102, "Uniform requirements for grants to State and local governments."

3. *Background.* The Single Audit Act builds upon earlier efforts to improve audits of Federal aid programs. The Act requires State or local governments that receive \$100,000 or more a year in Federal funds to have an audit made for that year. Section 7505 of the Act requires the Director of the Office of Management and Budget to prescribe policies, procedures and guidelines to implement the Act. It specifies that the Director shall designate "cognizant" Federal agencies, determine criteria for making appropriate charges to Federal programs for the cost of audits, and provide procedures to assure that small firms or firms owned and controlled by disadvantaged individuals have the opportunity to participate in contracts for single audits.

4. *Policy.* The Single Audit Act requires the following:

a. State or local governments that receive \$100,000 or more a year in Federal financial assistance shall have an audit made in accordance with this Circular.

b. State or local governments that receive between \$25,000 and \$100,000 a year shall have an audit made in accordance with this Circular, or in accordance with Federal laws and regulations governing the programs they participate in.

c. State or local governments that receive less than \$25,000 a year shall be exempt from compliance with the Act and other Federal audit requirements. These State and local governments shall be governed by audit requirements prescribed by State or local law or regulation.

d. Nothing in this paragraph exempts State or local governments from maintaining records of Federal financial assistance or from providing access to such records to Federal agencies, as provided for in Federal law or in Circular A-102, "Uniform requirements for grants to State or local governments."

5. *Definitions.* For the purposes of this Circular the following definitions from the Single Audit Act apply:

a. "Cognizant agency" means the Federal agency assigned by the Office of Management and Budget to carry out the responsibilities described in paragraph 11 of this Circular.

b. "Federal financial assistance" means assistance provided by a Federal agency in the form of grants, contracts, cooperative agreements, loans, loan guarantees, property, interest subsidies, insurance, or direct appropriations, but does not include direct Federal cash assistance to individuals. It includes awards received directly from Federal agencies, or indirectly through other units of State and local governments.

c. "Federal agency" has the same meaning as the term 'agency' in section 551(1) of Title 5, United States Code.

d. "Generally accepted accounting principles" has the meaning specified in the generally accepted government auditing standards.

e. “Generally accepted government auditing standards” means the *Standards for Audit of Government Organizations, Programs, Activities, and Functions*, developed by the Comptroller General, dated February 27, 1981.

f. “Independent auditor” means:

(1) a State or local government auditor who meets the independence standards specified in generally accepted government auditing standards; or

(2) a public accountant who meets such independence standards.

g. “Internal controls” means the plan of organization and methods and procedures adopted by management to ensure that:

(1) resource use is consistent with laws, regulations, and policies;

(2) resources are safeguarded against waste, loss, and misuse; and

(3) reliable data are obtained, maintained, and fairly disclosed in reports.

h. “Indian tribe” means any Indian tribe, band, nations, or other organized group or community, including any Alaskan Native village or regional or village corporations (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

i. “Local government” means any unit of local government within a State, including a county, a borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

j. “Major Federal Assistance Program,” as defined by P.L. 98-502, is described in the Attachment to this Circular.

k. “Public accountants” means those individuals who meet the qualification standards included in generally accepted government auditing standards for personnel performing government audits.

l. “State” means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, and any multi-State, regional, or interstate entity that has governmental functions and any Indian tribe.

m. “Subrecipient” means any person or government department, agency, or establishment that receives Federal financial assistance to carry out a program through a State or local government, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a direct recipient of Federal financial assistance.

6. *Scope of audit.* The Single Audit Act provides that:

a. The audit shall be made by an independent auditor in accordance with generally accepted government auditing standards covering financial and compliance audits.



b. The audit shall cover the entire operations of a State or local government or, at the option of that government, it may cover departments, agencies or establishments that received, expended, or otherwise administered Federal financial assistance during the year. However, if a State or local government receives \$ 25,000 or more in General Revenue Sharing Funds in a fiscal year, it shall have an audit of its entire operations. A series of audits of individual departments, agencies, and establishments for the same fiscal year may be considered a single audit.

c. Public hospitals and public colleges and universities may be excluded from State and local audits and the requirements of this Circular. However, if such entities are excluded, audits of these entities shall be made in accordance with statutory requirements and the provisions of Circular A-110, "Uniform requirements for grants to universities, hospitals, and other nonprofit organizations."

d. The auditor shall determine whether:

(1) the financial statements of the government, department, agency or establishment present fairly its financial position and the results of its financial operations in accordance with generally accepted accounting principles;

(2) the organization has internal accounting and other control systems to provide reasonable assurance that it is managing Federal financial assistance programs in compliance with applicable laws and regulations; and

(3) the organization has complied with laws and regulations that may have material effect on its financial statements and on each major Federal assistance program.

7. *Frequency of audit.* Audits shall be made annually unless the State or local government has, by January 1, 1987, a constitutional or statutory requirement for less frequent audits. For those governments, the cognizant agency shall permit biennial audits, covering both years, if the government so requests. It shall also honor requests for biennial audits by governments that have an administrative policy calling for audits less frequent than annual, but only for fiscal years beginning before January 1, 1987.

8. *Internal control and compliance reviews.* The Single Audit Act requires that the independent auditor determine and report on whether the organization has internal control systems to provide reasonable assurance that it is managing Federal assistance programs in compliance with applicable laws and regulations.

a. *Internal control review.* In order to provide this assurance the auditor must make a study and evaluation of internal control systems used in administering Federal assistance programs. The study and evaluation must be made whether or not the auditor intends to place reliance on such systems. As part of this review, the auditor shall:

(1) Test whether these internal control systems are functioning in accordance with prescribed procedures.

(2) Examine the recipient's system for monitoring subrecipients and obtaining and acting on subrecipient audit reports.

b. *Compliance review.* The law also requires the auditor to determine whether the organization has complied with laws and regulations that may have a material effect on each major Federal assistance program.

(1) In order to determine which major programs are to be tested for compliance, State and local governments shall identify in their accounts all Federal funds received and expended and the programs under which they were received. This shall include funds received directly from Federal agencies and through other State and local governments.

(2) The review must include the selection and testing of a representative number of charges from each major Federal assistance program. The selection and testing of transactions shall be based on the auditor's professional judgment considering such factors as the amount of expenditures for the program and the individual awards; the newness of the program or changes in its conditions; prior experience with the program, particularly as revealed in audits and other evaluations (e.g., inspections, program reviews); the extent to which the program is carried out through subrecipients; the extent to which the program contracts for goods or services; the level to which the program is already subject to program reviews or other forms of independent oversight; the adequacy of the controls for ensuring compliance; the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

(a) In making the test of transactions, the auditor shall determine whether:

- the amounts reported as expenditures were for allowable services, and
- the records show that those who received services or benefits were eligible to receive them.

(b) In addition to transaction testing, the auditor shall determine whether:

- matching requirements, levels of effort and earmarking limitations were met,
- Federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared, and
- amounts claimed or used for matching were determined in accordance with OMB Circular A-87, "Cost principles for State and local governments," and Attachment F of Circular A-102, "Uniform requirements for grants to State and local governments."

(c) The principal compliance requirements of the largest Federal aid programs may be ascertained by referring to the *Compliance Supplement for Single Audits of State and Local Governments*, issued by OMB and available from the Government Printing Office. For those programs not covered in the Compliance Supplement, the auditor may ascertain compliance requirements by researching the statutes, regulations, and agreements governing individual programs.

(3) Transactions related to other Federal assistance programs that are selected in connection with examinations of financial statements and

evaluations of internal controls shall be tested for compliance with Federal laws and regulations that apply to such transactions.

**9. Subrecipients.** State or local governments that receive Federal financial assistance and provide \$25,000 or more of it in a fiscal year to a subrecipient shall:

a. determine whether State or local subrecipients have met the audit requirements of this Circular and whether subrecipients covered by Circular A-110, "Uniform requirements for grants to universities, hospitals, and other nonprofit organizations," have met that requirement;

b. determine whether the subrecipient spent Federal assistance funds provided in accordance with applicable laws and regulations. This may be accomplished by reviewing an audit of the subrecipient made in accordance with this Circular, Circular A-110, or through other means (e.g., program reviews) if the subrecipient has not yet had such an audit;

c. ensure that appropriate corrective action is taken within six months after receipt of the audit report in instances of noncompliance with Federal laws and regulations;

d. consider whether subrecipient audits necessitate adjustment of the recipient's own records; and

e. require each subrecipient to permit independent auditors to have access to the records and financial statements as necessary to comply with this Circular.

**10. Relation to other audit requirements.** The Single Audit Act provides that an audit made in accordance with this Circular shall be in lieu of any financial or financial compliance audit required under individual Federal assistance programs. To the extent that a single audit provides Federal agencies with information and assurances they need to carry out their overall responsibilities, they shall rely upon and use such information. However, a Federal agency shall make any additional audits which are necessary to carry out its responsibilities under Federal law and regulation. Any additional Federal audit effort shall be planned and carried out in such a way as to avoid duplication.

a. The provisions of this Circular do not limit the authority of Federal agencies to make, or contract for audits and evaluations of Federal financial assistance programs, nor do they limit the authority of any Federal agency Inspector General or other Federal audit official.

b. The provisions of this Circular do not authorize any State or local government or subrecipient thereof to constrain Federal agencies, in any manner, from carrying out additional audits.

c. A Federal agency that makes or contracts for audits in addition to the audits made by recipients pursuant to this Circular shall, consistent with other applicable laws and regulations, arrange for funding the cost of such additional audits. Such additional audits include economy and efficiency audits, program results audits, and program evaluations.

**11. Cognizant agency responsibilities.** The Single Audit Act provides for cognizant Federal agencies to oversee the implementation of this Circular.

a. The Office of Management and Budget will assign cognizant agencies for States and their subdivisions and larger local governments and their subdivisions. Other Federal agencies may participate with an

assigned cognizant agency, in order to fulfill the cognizance responsibilities. Smaller governments not assigned a cognizant agency will be under the general oversight of the Federal agency that provides them the most funds whether directly or indirectly.

b. A cognizant agency shall have the following responsibilities:

(1) Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of this Circular.

(2) Provide technical advice and liaison to State and local governments and independent auditors.

(3) Obtain or make quality control reviews of selected audits made by non-Federal audit organizations, and provide the results, when appropriate, to other interested organizations.

(4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any reported illegal acts or irregularities. They should also inform State or local law enforcement and prosecuting authorities, if not advised by the recipient, of any violation of law within their jurisdiction.

(5) Advise the recipient of audits that have been found not to have met the requirements set forth in this Circular. In such instances, the recipient will be expected to work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient and Federal awarding agencies of the facts and make recommendations for followup action. Major inadequacies or repetitive substandard performance of independent auditors shall be referred to appropriate professional bodies for disciplinary action.

(6) Coordinate, to the extent practicable, audits made by or for Federal agencies that are in addition to the audits made pursuant to this Circular; so that the additional audits build upon such audits.

(7) Oversee the resolution of audit findings that affect the programs of more than one agency.

**12. *Illegal acts or irregularities.*** If the auditor becomes aware of illegal acts or other irregularities, prompt notice shall be given to recipient management officials above the level of involvement. (See also paragraph 13(a)(3) below for the auditor's reporting responsibilities.) The recipient, in turn, shall promptly notify the cognizant agency of the illegal acts or irregularities and of proposed and actual actions, if any. Illegal acts and irregularities include such matters as conflicts of interest, falsification of records or reports, and misappropriations of funds or other assets.

**13. *Audit reports.*** Audit reports must be prepared at the completion of the audit. Reports serve many needs of State and local governments as well as meeting the requirements of the Single Audit Act.

a. The audit report shall state that the audit was made in accordance with the provisions of this Circular. The report shall be made up of at least:

(1) The auditor's report on financial statements and on a schedule of Federal assistance; the financial statements; and a schedule

of Federal assistance, showing the total expenditures for each Federal assistance program as identified in the *Catalog of Federal Domestic Assistance*. Federal programs or grants that have not been assigned a catalog number shall be identified under the caption "other Federal assistance."

(2) The auditor's report on the study and evaluation of internal control systems must identify the organization's significant internal accounting controls, and those controls designed to provide reasonable assurance that Federal programs are being managed in compliance with laws and regulations. It must also identify the controls that were evaluated, the controls that were not evaluated, and the material weaknesses identified as a result of the evaluation.

(3) The auditor's report on compliance containing:

- a statement of positive assurance with respect to those items tested for compliance, including compliance with law and regulations pertaining to financial reports and claims for advances and reimbursements;
- negative assurance on those items not tested;
- a summary of all instances of noncompliance; and
- an identification of total amounts questioned, if any, for each Federal assistance award, as a result of noncompliance.

b. The three parts of the audit report may be bound into a single report, or presented at the same time as separate documents.

c. All fraud abuse, or illegal acts or indications of such acts, including all questioned costs found as the result of these acts that auditors become aware of, should normally be covered in a separate written report submitted in accordance with paragraph 13f.

d. In addition to the audit report, the recipient shall provide comments on the findings and recommendations in the report, including a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings. If corrective action is not necessary, a statement describing the reason it is not should accompany the audit report.

e. The reports shall be made available by the State or local government for public inspection within 30 days after the completion of the audit.

f. In accordance with generally accepted government audit standards, reports shall be submitted by the auditor to the organization audited and to those requiring or arranging for the audit. In addition, the recipient shall submit copies of the reports to each Federal department or agency that provided Federal assistance funds to the recipient. Subrecipients shall submit copies to recipients that provided them Federal assistance funds. The reports shall be sent within 30 days after the completion of the audit, but no later than one year after the end of the audit period unless a longer period is agreed to with the cognizant agency.

g. Recipients of more than \$100,000 in Federal funds shall submit one copy of the audit report within 30 days after issuance to a central clearinghouse to be designated by the Office of Management and Budget. The clearinghouse will keep completed audits on file and follow up with State and local governments that have not submitted required audit reports.

h. Recipients shall keep audit reports on file for three years from their issuance.

14. *Audit resolution.* As provided in paragraph 11, the cognizant agency shall be responsible for monitoring the resolution of audit findings that affect the programs of more than one Federal agency. Resolution of findings that relate to the programs of a single Federal agency will be the responsibility of the recipient and that agency. Alternate arrangements may be made on a case-by-case basis by agreement among the agencies concerned.

Resolution shall be made within six months after receipt of the report by the Federal departments and agencies. Corrective action should proceed as rapidly as possible.

15. *Audit workpapers and reports.* Workpapers and reports shall be retained for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Audit workpapers shall be made available upon request to the cognizant agency or its designee or the General Accounting Office, at the completion of the audit.

16. *Audit costs.* The cost of audits made in accordance with the provisions of this Circular are allowable charges to Federal assistance programs.

a. The charges may be considered a direct cost or an allocated indirect cost, determined in accordance with the provision of Circular A-87, "Cost principles for State and local governments."

b. Generally, the percentage of costs charged to Federal assistance programs for a single audit shall not exceed the percentage that Federal funds expended represent of total funds expended by the recipient during the fiscal year. The percentage may be exceeded, however, if appropriate documentation demonstrates higher actual cost.

17. *Sanctions.* The Single Audit Act provides that no cost may be charged to Federal assistance programs for audits required by the Act that are not made in accordance with this Circular. In cases of continued inability or unwillingness to have a proper audit, Federal agencies must consider other appropriate sanctions including:

- withholding a percentage of assistance payments until the audit is completed satisfactorily
- withholding or disallowing overhead costs, and
- suspending the Federal assistance agreement until the audit is made.

18. *Auditor selection.* In arranging for audit services State and local governments shall follow the procurement standards prescribed by Attachment O of Circular A-102, "Uniform requirements for grants to State and local governments." The standards provide that while recipients are encouraged to enter into intergovernmental agreements for audit and other services, analysis should be made to determine whether it would be more economical to purchase the services from private firms. In instances where use of such intergovernmental agreements are required by State statutes (e.g., audit services) these statutes will take precedence.

19. *Small and minority audit firms.* Small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals

shall have the maximum practicable opportunity to participate in contracts awarded to fulfill the requirements of this Circular. Recipients of Federal assistance shall take the following steps to further this goal:

a. Assure that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals are used to the fullest extent practicable.

b. Make information on forthcoming opportunities available and arrange timeframes for the audit so as to encourage and facilitate participation by small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals.

c. Consider in the contract process whether firms competing for larger audits intend to subcontract with small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals.

d. Encourage contracting with small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals which have traditionally audited government programs and, in such cases where this is not possible, assure that these firms are given consideration for audit subcontracting opportunities.

e. Encourage contracting with consortiums of small audit firms as described in paragraph (a) above when a contract is too large for an individual small audit firm or audit firm owned and controlled by socially and economically disadvantaged individuals.

f. Use the services and assistance, as appropriate, of such organizations as the Small Business Administration in the solicitation and utilization of small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals.

**20. Reporting.** Each Federal agency will report to the Director of OMB on or before March 1, 1987, and annually thereafter on the effectiveness of State and local governments in carrying out the provisions of this Circular. The report must identify each State or local government or Indian tribe that, in the opinion of the agency, is failing to comply with the Circular.

**21. Regulations.** Each Federal agency shall include the provisions of this Circular in its regulations implementing the Single Audit Act.

**22. Effective date.** This Circular is effective upon publication and shall apply to fiscal years of State and local governments that begin after December 31, 1984. Earlier implementation is encouraged. However, until it is implemented, the audit provisions of Attachment P to Circular A-102 shall continue to be observed.

**23. Inquiries.** All questions or inquiries should be addressed to Financial Management Division, Office of Management and Budget, telephone number 202/395-3993.

**24. Sunset review date.** This Circular shall have an independent policy review to ascertain its effectiveness three years from the date of issuance.

David A. Stockman,  
Director

## Circular A-128 Attachment

### Definition of Major Program as Provided in P.L. 98-502

"Major Federal Assistance Program," for State and local governments, having Federal assistance expenditures between \$100,000 and \$100,000,000, means any program for which Federal expenditures during the applicable year exceed the larger of \$300,000, or 3 percent of such total expenditures.

Where total expenditures of Federal assistance exceed \$100,000,000, the following criteria apply:

<i>Total Expenditures of Federal Financial Assistance for All Programs</i>		<i>Major Federal Assistance Program Means Any Program That Exceeds</i>
<i>more than</i>	<i>but less than</i>	
\$100 million	1 billion	\$ 3 million
1 billion	2 billion	4 million
2 billion	3 billion	7 million
3 billion	4 billion	10 million
4 billion	5 billion	13 million
5 billion	6 billion	16 million
6 billion	7 billion	19 million
over 7 billion		20 million



## Appendix F

# **The Common Rule—Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments**

**Note:** The auditor should consult the Code of Federal regulations for information on Federal agency implementation of the Common Rule. See the last page of this appendix for further information.

### **PART \_\_ —UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS**

#### **Subpart A—General**

*Sec.*

- \_\_1 Purpose and scope of this part.
- \_\_2 Scope of subpart.
- \_\_3 Definitions.
- \_\_4 Applicability.
- \_\_5 Effect on other issuances.
- \_\_6 Additions and exceptions.

#### **Subpart B—Pre-Award Requirements**

- \_\_10 Forms for applying for grants.
- \_\_11 State plans.
- \_\_12 Special grant or subgrant conditions for “high-risk” grantees.

#### **Subpart C—Post-Award Requirements**

##### **Financial Administration**

- \_\_20 Standards for financial management systems.
- \_\_21 Payment.
- \_\_22 Allowable costs.
- \_\_23 Period of availability of funds.
- \_\_24 Matching or cost sharing.
- \_\_25 Program income.
- \_\_26 Non-Federal audit.

##### **Changes, Property, and Subawards**

- \_\_30 Changes.
- \_\_31 Real property.
- \_\_32 Equipment.
- \_\_33 Supplies.
- \_\_34 Copyrights.

- \_\_\_35 Subawards to debarred and suspended parties.
- \_\_\_36 Procurement.
- \_\_\_37 Subgrants.

**Reports, Records, Retention, and Enforcement**

- \_\_\_40 Monitoring and reporting program performance.
- \_\_\_41 Financial reporting.
- \_\_\_42 Retention and access requirements for records.
- \_\_\_43 Enforcement.
- \_\_\_44 Termination for convenience.

**Subpart D—After-the-Grant Requirements**

- \_\_\_50 Closeout.
- \_\_\_51 Later disallowances and adjustments.
- \_\_\_52 Collection of amounts due.

**Subpart E—Entitlements (Reserved)**

**Subpart A—General**

**§ \_\_\_.1 Purpose and scope of this part.**

This part establishes uniform administrative rules for Federal grants and cooperative agreements and subawards to State, local and Indian tribal governments.

**§ \_\_\_.2 Scope of subpart.**

This subpart contains general rules pertaining to this part and procedures for control of exceptions from this part.

**§ \_\_\_.3 Definitions.**

As used in this part:

“Accrued expenditures” mean the charges incurred by the grantee during a given period requiring the provision of funds for: (1) Goods and other tangible property received; (2) services performed by employees, contractors, subgrantees, subcontractors, and other payees; and (3) other amounts becoming owed under programs for which no current services or performance is required, such as annuities, insurance claims, and other benefit payments.

“Accrued income” means the sum of: (1) Earnings during a given period from services performed by the grantee and goods and other tangible property delivered to purchasers, and (2) amounts becoming owed to the grantee for which no current services or performance is required by the grantee.

“Acquisition cost” of an item of purchased equipment means the net invoice unit price of the property including the cost of modifications, attachments, accessories, or auxiliary apparatus necessary to make the property usable for the purpose for which it was acquired. Other charges such as the cost of installation, transportation, taxes, duty or protective in-transit insurance, shall be included or excluded from the unit acquisition cost in accordance with the grantee’s regular accounting practices.

“Administrative” requirements mean those matters common to grants in general, such as financial management, kinds and frequency of reports, and retention of records. These are distinguished from “programmatic” requirements, which concern matters that can be treated only on a program-by-program or grant-by-grant basis, such as kinds of activities that can be supported by grants under a particular program.

“Awarding agency” means (1) with respect to a grant, the Federal agency, and (2) with respect to a subgrant, the party that awarded the subgrant.

“Cash contributions” means the grantee’s cash outlay, including the outlay of money contributed to the grantee or subgrantee by other public agencies and institutions, and private organizations and individuals. When authorized by Federal legislation, Federal funds received from other assistance agreements may be considered as grantee or subgrantee cash contributions.

“Contract” means (except as used in the definitions for “grant” and “subgrant” in this section and except where qualified by “Federal”) a procurement contract under a grant or subgrant, and means a procurement subcontract under a contract.

“Cost sharing or matching” means the value of the third party in-kind contributions and the portion of the costs of a federally assisted project or program not borne by the Federal Government.

“Cost-type contract” means a contract or subcontract under a grant in which the contractor or subcontractor is paid on the basis of the costs it incurs, with or without a fee.

“Equipment” means tangible, nonexpendable, personal property having a useful life of more than one year and an acquisition cost of \$5,000 or more per unit. A grantee may use its own definition of equipment provided that such definition would at least include all equipment defined above.

“Expenditure report” means: (1) For nonconstruction grants, the SF-269 “Financial Status Report” (or other equivalent report); (2) for construction grants, the SF-271 “Outlay Report and Request for Reimbursement” (or other equivalent report).

“Federally recognized Indian tribal government” means the governing body or a governmental agency of any Indian tribe, band, nation, or other organized group or community (including any Native village as defined in section 3 of the Alaska Native Claims Settlement Act, 85 Stat 688) certified by the Secretary of the Interior as eligible for the special programs and services provided by him through the Bureau of Indian Affairs.

“Government” means a State or local government or a federally recognized Indian tribal government.

“Grant” means an award of financial assistance, including cooperative agreements, in the form of money, or property in lieu of money, by the Federal Government to an eligible grantee. The term does not include technical assistance which provides services instead of money, or other assistance in the form of revenue sharing, loans, loan guarantees, interest subsidies, insurance, or direct appropriations. Also, the term does not include assistance, such as a fellowship or other lump sum award, which the grantee is not required to account for.

“Grantee” means the government to which a grant is awarded and which is accountable for the use of the funds provided. The grantee is the entire legal entity even if only a particular component of the entity is designated in the grant award document.

“Local government” means a county, municipality, city, town, township, local public authority (including any public and Indian housing agency under the United States Housing Act of 1937) school district, special district, intrastate district, council of governments (whether or not incorporated as a nonprofit corporation under state law), any other regional or interstate government entity, or any agency or instrumentality of a local government.

“Obligations” means the amounts of orders placed, contracts and subgrants awarded, goods and services received, and similar transactions during a given period that will require payment by the grantee during the same or a future period.

“OMB” means the United States Office of Management and Budget.

“Outlays” (expenditures) mean charges made to the project or program. They may be reported on a cash or accrual basis. For reports prepared on a cash basis, outlays are the sum of actual cash disbursement for direct charges for goods and services, the amount of indirect expense incurred, the value of in-kind contributions applied, and the amount of cash advances and payments made to contractors and subgrantees. For reports prepared on an accrued expenditure basis, outlays are the sum of actual cash disbursements, the amount of indirect expense incurred, the value of in-kind contributions applied, and the net increase (or decrease) in the amounts owed by the grantee for goods and other property received, for services performed by employees, contractors, subgrantees, subcontractors, and other payees, and other amounts becoming owed under programs for which no current services or performance are required, such as annuities, insurance claims, and other benefit payments.

“Percentage of completion method” refers to a system under which payments are made for construction work according to the percentage of completion of the work, rather than to the grantee’s cost incurred.

“Prior approval” means documentation evidencing consent prior to incurring specific cost.

“Real property” means land, including land improvements, structures and appurtenances thereto, excluding movable machinery and equipment.

“Share,” when referring to the awarding agency’s portion of real property, equipment or supplies, means the same percentage as the awarding agency’s portion of the acquiring party’s total costs under the grant to which the acquisition costs under the grant to which the acquisition cost of the property was charged. Only costs are to be counted—not the value of third-party in-kind contributions.

“State” means any of the several States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or any agency or instrumentality of a State exclusive of local governments. The term does not include any public and Indian housing agency under United States Housing Act of 1937.

“Subgrant” means an award of financial assistance in the form of money, or property in lieu of money, made under a grant by a grantee to an eligible subgrantee. The term includes financial assistance when provided by contractual legal agreement, but does not include procurement purchases, nor does it include any form of assistance which is excluded from the definition of “grant” in this part.

“Subgrantee” means the government or other legal entity to which a subgrant is awarded and which is accountable to the grantee for the use of the funds provided.

“Supplies” means all tangible personal property other than “equipment” as defined in this part.

“Suspension” means depending on the context, either (1) temporary withdrawal of the authority to obligate grant funds pending corrective action by the grantee or subgrantee or a decision to terminate the grant, or (2) an action tak-

en by a suspending official in accordance with agency regulations implementing E.O. 12549 to immediately exclude a person from participating in grant transactions for a period pending completion of an investigation and such legal or debarment proceedings as may ensue.

“Termination” means permanent withdrawal of the authority to obligate previously-awarded grant funds before that authority would otherwise expire. It also means the voluntary relinquishment of that authority by the grantee or subgrantee. “Termination” does not include: (1) Withdrawal of funds awarded on the basis of the grantee’s underestimate of the unobligated balance in a prior period; (2) Withdrawal of the unobligated balance as of the expiration of a grant; (3) Refusal to extend a grant or award additional funds, to make a competing or noncompeting continuation, renewal, extension, or supplemental award; or (4) voiding of a grant upon determination that the award was obtained fraudulently, or was otherwise illegal or invalid from inception.

“Terms of a grant or subgrant” mean all requirements of the grant or subgrant, whether in statute, regulations, or the award document.

“Third party in-kind contributions” mean property or services which benefit a federally assisted project or program and which are contributed by non-Federal third parties without charge to the grantee, or a cost-type contractor under the grant agreement.

“Unliquidated obligations” for reports prepared on a cash basis mean the amount of obligations incurred by the grantee that has not been paid. For reports prepared on an accrued expenditure basis, they represent the amount of obligations incurred by the grantee for which an outlay has not been recorded.

“Unobligated balance” means the portion of the funds authorized by the Federal agency that has not been obligated by the grantee and is determined by deducting the cumulative obligations from the cumulative funds authorized.

#### **§ \_\_\_\_\_.4 Applicability.**

(a) *General.* Subparts A-D of this part apply to all grants and subgrants to governments, except where inconsistent with Federal statutes or with regulations authorized in accordance with the exception provision of § \_\_\_\_\_.6, or:

(1) Grants and subgrants to State and local institutions of higher education or State and local hospitals.

(2) The block grants authorized by the Omnibus Budget Reconciliation Act of 1981 (Community Services; Preventive Health and Health Services; Alcohol, Drug Abuse, and Mental Health Services; Maternal and Child Health Services; Social Services; Low-Income Home Energy Assistance; States’ Program of Community Development Block Grants for Small Cities; and Elementary and Secondary Education other than programs administered by the Secretary of Education under Title V, Subtitle D, Chapter 2, Section 583—the Secretary’s discretionary grant program) and Titles I-III of the Job Training Partnership Act of 1982 and under the Public Health Services Act (Section 1921), Alcohol and Drug Abuse Treatment and Rehabilitation Block Grant and Part C of Title V, Mental Health Service for the Homeless Block Grant).

(3) Entitlement grants to carry out the following programs of the Social Security Act:

(i) Aid to Needy Families with Dependent Children (Title IV-A of the Act, not including the Work Incentive Program (WIN) authorized by section 402(a)19(G); HHS grants for WIN are subject to this part);

(ii) Child Support Enforcement and Establishment of Paternity (Title IV-D of the Act);

(iii) Foster Care and Adoption Assistance (Title IV-E of the Act);

(iv) Aid to the Aged, Blind, and Disabled (Titles I, X, XIV, and XVI-AABD of the Act); and

(v) Medical Assistance (Medicaid) (Title XIX of the Act) not including the State Medicaid Fraud Control program authorized by section 1903(a)(6)(B).

(4) Entitlement grants under the following programs of The National School Lunch Act:

(i) School Lunch (section 4 of the Act),

(ii) Commodity Assistance (section 6 of the Act),

(iii) Special Meal Assistance (section 11 of the Act),

(iv) Summer Food Service for Children (section 13 of the Act), and

(v) Child Care Food Program (section 17 of the Act).

(5) Entitlement grants under the following programs of The Child Nutrition Act of 1966:

(i) Special Milk (section 3 of the Act), and

(ii) School Breakfast (section 4 of the Act).

(6) Entitlement grants for State Administrative expenses under The Food Stamp Act of 1977 (section 16 of the Act).

(7) A grant for an experimental, pilot, or demonstration project that is also supported by a grant listed in paragraph (a)(3) of this section;

(8) Grant funds awarded under subsection 412(e) of the Immigration and Nationality Act (8 U.S.C. 1522(e)) and subsection 501(a) of the Refugee Education Assistance Act of 1980 (Pub. L. 96-422, 94 Stat. 1809), for cash assistance, medical assistance, and supplemental security income benefits to refugees and entrants and the administrative costs of providing the assistance and benefits;

(9) Grants to local education agencies under 20 U.S.C. 236 through 241-1(a), and 242 through 244 (portions of the Impact Aid program), except for 20 U.S.C. 238(d)(2)(c) and 240(f) (Entitlement Increase for Handicapped Children); and

(10) Payments under the Veterans Administration's State Home Per Diem Program (38 U.S.C. 641(a)).

(b) *Entitlement programs.* Entitlement programs enumerated above in § \_\_\_\_ .4 (a)(3)-(8) are subject to Subpart E.

#### § \_\_\_\_ .5 **Effect on other issuances.**

All other grants administration provisions of codified program regulations, program manuals, handbooks and other nonregulatory materials which are inconsistent with this part are superseded, except to the extent they are required by statute, or authorized in accordance with the exception provision in § \_\_\_\_ .6.

#### § \_\_\_\_ .6 **Additions and exceptions.**

(a) For classes of grants and grantees subject to this part, Federal agencies may not impose additional administrative requirements except in codified regulations published in the **Federal Register**.

(b) Exceptions for classes of grants or grantees may be authorized only by OMB.

(c) Exceptions on a case-by-case basis and for subgrantees may be authorized by the affected Federal agencies.

**Subpart B—Pre-Award Requirements****§ \_\_.10 Forms for applying for grants.**

(a) *Scope.* (1) This section prescribes forms and instructions to be used by governmental organizations (except hospitals and institutions of higher education operated by a government) in applying for grants. This section is not applicable, however, to formula grant programs which do not require applicants to apply for funds on a project basis.

(2) This section applies only to applications to Federal agencies for grants, and is not required to be applied by grantees in dealing with applicants for subgrants. However, grantees are encouraged to avoid more detailed or burdensome application requirements for subgrants.

(b) *Authorized forms and instructions for governmental organizations.* (1) In applying for grants, applicants shall only use standard application forms or those prescribed by the granting agency with the approval of OMB under the Paperwork Reduction Act of 1980.

(2) Applicants are not required to submit more than the original and two copies of preapplications or applications.

(3) Applicants must follow all applicable instructions that bear OMB clearance numbers. Federal agencies may specify and describe the programs, functions, or activities that will be used to plan, budget, and evaluate the work under a grant. Other supplementary instructions may be issued only with the approval of OMB to the extent required under the Paperwork Reduction Act of 1980. For any standard form, except the SF-424 facesheet, Federal agencies may shade out or instruct the applicant to disregard any line item that is not needed.

(4) When a grantee applies for additional funding (such as a continuation or supplemental award) or amends a previously submitted application, only the affected pages need be submitted. Previously submitted pages with information that is still current need not be resubmitted.

**§ \_\_.11 State plans.**

(a) *Scope.* The statutes for some programs require States to submit plans before receiving grants. Under regulations implementing Executive Order 12372, "Intergovernmental Review of Federal Programs," States are allowed to simplify, consolidate and substitute plans. This section contains additional provisions for plans that are subject to regulations implementing the Executive Order.

(b) *Requirements.* A State need meet only Federal administrative or programmatic requirements for a plan that are in statutes or codified regulations.

(c) *Assurances.* In each plan the State will include an assurance that the State shall comply with all applicable Federal statutes and regulations in effect with respect to the periods for which it receives grant funding. For this assurance and other assurances required in the plan, the State may:

(1) Cite by number the statutory or regulatory provisions requiring the assurances and affirm that it gives the assurances required by those provisions.

(2) Repeat the assurance language in the statutes or regulations, or

(3) Develop its own language to the extent permitted by law.

(d) *Amendments.* A State will amend a plan whenever necessary to reflect: (1) New or revised Federal statutes or regulations or (2) a material change in any State law, organization, policy, or State agency operation. The State will obtain approval for the amendment and its effective date but need submit for approval only the amended portions of the plan.

**§ \_\_\_\_ .12 Special grant or subgrant conditions for “high-risk” grantees.**

(a) A grantee or subgrantee may be considered “high risk” if an awarding agency determines that a grantee or subgrantee:

- (1) Has a history of unsatisfactory performance, or
- (2) Is not financially stable, or
- (3) Has a management system which does not meet the management standards set forth in this part, or
- (4) Has not conformed to terms and conditions of previous awards, or
- (5) Is otherwise not responsible; and if the awarding agency determines that an award will be made, special conditions and/or restrictions shall correspond to the high risk condition and shall be included in the award.

(b) Special conditions or restrictions may include:

- (1) Payment on a reimbursement basis;
- (2) Withholding authority to proceed to the next phase until receipt of evidence of acceptable performance within a given funding period;
- (3) Requiring additional, more detailed financial reports;
- (4) Additional project monitoring;
- (5) Requiring the grantee or subgrantee to obtain technical or management assistance; or
- (6) Establishing additional prior approvals.

(c) If an awarding agency decides to impose such conditions, the awarding official will notify the grantee or subgrantee as early as possible, in writing, of:

- (1) The nature of the special conditions/restrictions;
- (2) The reason(s) for imposing them;
- (3) The corrective actions which must be taken before they will be removed and the time allowed for completing the corrective actions and
- (4) The method of requesting reconsideration of the conditions/restrictions imposed.

**Subpart C—Post-Award Requirements**

**Financial Administration**

**§ \_\_\_\_ .20 Standards for financial management systems.**

(a) A State must expand and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to—

- (1) Permit preparation of reports required by this part and the statutes authorizing the grant, and
- (2) Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

(b) The financial management systems of other grantees and subgrantees must meet the following standards:



(1) *Financial reporting.* Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.

(2) *Accounting records.* Grantees and subgrantees must maintain records which adequately identify the source and application of funds provided for financially-assisted activities. These records must contain information pertaining to grant or subgrant awards and authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, and income.

(3) *Internal control.* Effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets. Grantees and subgrantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes.

(4) *Budget control.* Actual expenditures or outlays must be compared with budgeted amounts for each grant or subgrant. Financial information must be related to performance or productivity data, including the development of unit cost information whenever appropriate or specifically required in the grant or subgrant agreement. If unit cost data are required, estimates based on available documentation will be accepted whenever possible.

(5) *Allowable cost.* Applicable OMB cost principles, agency program regulations, and the terms of grant and subgrant agreements will be followed in determining the reasonableness, allowability, and allocability of costs.

(6) *Source documentation.* Accounting records must be supported by such source documentation as cancelled checks, paid bills, payrolls, time and attendance records, contract and subgrant award documents, etc.

(7) *Cash management.* Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to assure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

(c) An awarding agency may review the adequacy of the financial management system of any applicant for financial assistance as part of a preaward review or at any time subsequent to award.

#### **§ \_\_.21 Payment.**

(a) *Scope.* This section prescribes the basic standard and the methods under which a Federal agency will make payments to grantees, and grantees will make payments to subgrantees and contractors.

(b) *Basic standard.* Methods and procedures for payment shall minimize the time elapsing between the transfer of funds and disbursement by the grantee or subgrantee, in accordance with Treasury regulations at 31 CFR Part 205.

(c) *Advances.* Grantees and subgrantees shall be paid in advance, provided they maintain or demonstrate the willingness and ability to maintain procedures to minimize the time elapsing between the transfer of the funds and their disbursement by the grantee or subgrantee.

(d) *Reimbursement.* Reimbursement shall be the preferred method when the requirements in paragraph (c) of this section are not met. Grantees and subgrantees may also be paid by reimbursement for any construction grant. Except as otherwise specified in regulation, Federal agencies shall not use the percentage of completion method to pay construction grants. The grantee or subgrantee may use that method to pay its construction contractor, and if it does, the awarding agency's payments to the grantee or subgrantee will be based on the grantee's or subgrantee's actual rate of disbursement.

(e) *Working capital advances.* If a grantee cannot meet the criteria for advance payments described in paragraph (c) of this section, and the Federal agency has determined that reimbursement is not feasible because the grantee lacks sufficient working capital, the awarding agency may provide cash or a working capital advance basis. Under this procedure the awarding agency shall advance cash to the grantee to cover its estimated disbursement needs for an initial period generally geared to the grantee's disbursing cycle. Thereafter, the awarding agency shall reimburse the grantee for its actual cash disbursements. The working capital advance method of payment shall not be used by grantees or subgrantees if the reason for using such method is the unwillingness or inability of the grantee to provide timely advances to the subgrantee to meet the subgrantee's actual cash disbursements.

(f) *Effect of program income, refunds, and audit recoveries on payment.*

(1) Grantees and subgrantees shall disburse repayments to and interest earned on a revolving fund before requesting additional cash payments for the same activity.

(2) Except as provided in paragraph (f)(1) of this section, grantees and subgrantees shall disburse program income, rebates, refunds, contract settlements, audit recoveries and interest earned on such funds before requesting additional cash payments.

(g) *Withholding payments.* (1) Unless otherwise required by Federal statute, awarding agencies shall not withhold payments for proper charges incurred by grantees or subgrantees unless—

(i) The grantee or subgrantee has failed to comply with grant award conditions or

(ii) The grantee or subgrantee is indebted to the United States.

(2) Cash withheld for failure to comply with grant award condition, but without suspension of the grant, shall be released to the grantee upon subsequent compliance. When a grant is suspended, payment adjustments will be made in accordance with § \_\_\_\_43(c).

(3) A Federal agency shall not make payment to grantees for amounts that are withheld by grantees or subgrantees from payment to contractors to assure satisfactory completion of work. Payments shall be made by the Federal agency when the grantees or subgrantees actually disburse the withheld funds to the contractors or to escrow accounts established to assure satisfactory completion of work.

(h) *Cash depositories.* (1) Consistent with the national goal of expanding the opportunities for minority business enterprises, grantees and subgrantees are encouraged to use minority banks (a bank which is owned at least 50 percent by minority group members). A list of minority owned banks can be obtained from the Minority Business Development Agency, Department of Commerce, Washington, DC 20230.

(2) A grantee or subgrantee shall maintain a separate bank account only when required by Federal-State agreement.

(i) *Interest earned on advances.* Except for interest earned on advances of funds exempt under the Intergovernmental Cooperation Act (31 U.S.C. 6501 et seq.) and the Indian Self-Determination Act (23 U.S.C. 450), grantees and subgrantees shall promptly, but at least quarterly, remit interest earned on advances to the Federal agency. The grantee or subgrantee may keep interest amounts up to \$100 per year for administrative expenses.

#### § \_\_.22 Allowable costs.

(a) *Limitation on use of funds.* Grant funds may be used only for:

(1) The allowable costs of the grantees, subgrantees and cost-type contractors, including allowable costs in the form of payments to fixed-price contractors; and

(2) Reasonable fees or profit to cost-type contractors but not any fee or profit (or other increment above allowable costs) to the grantee or subgrantee.

(b) *Applicable cost principles.* For each kind of organization, there is a set of Federal principles for determining allowable costs. Allowable costs will be determined in accordance with the cost principles applicable to the organization incurring the costs. The following chart lists the kinds of organizations and the applicable cost principles.

<i>For the costs of a—</i>	<i>Use the principles in—</i>
State, local or Indian tribal government.	OMB Circular A-87.
Private nonprofit organization other than an (1) institution of higher education, (2) hospital, or (3) organization named in OMB Circular A-122 as not subject to that circular.	OMB Circular A-122.
Educational institutions. . . . .	OMB Circular A-21.
For-profit organization other than a hospital and an organization named in OMB Circular A-122 as not subject to that circular.	48 CFR Part 31. Contract Cost Principles and Procedures, or uniform cost accounting standards that comply with cost principles acceptable to the Federal agency.

#### § \_\_.23 Period to availability of funds.

(a) *General.* Where a funding period is specified, a grantee may charge to the award only costs resulting from obligations of the funding period unless carryover of unobligated balances is permitted, in which case the carryover balances may be charged for costs resulting from obligations of the subsequent funding period.

(b) *Liquidation of obligations.* A grantee must liquidate all obligations incurred under the award not later than 90 days after the end of the funding period (or as specified in a program regulation) to coincide with the submission of the annual Financial Status Report (SF-269). The Federal agency may extend this deadline at the request of the grantee.

**§ \_\_\_\_ .24 Matching or cost sharing.**

(a) *Basic rule: Costs and contributions acceptable.* With the qualifications and exceptions listed in paragraph (b) of this section, a matching or cost sharing requirement may be satisfied by either or both of the following:

(1) Allowable costs incurred by the grantee, subgrantee or a cost-type contractor under the assistance agreement. This includes allowable costs borne by non-Federal grants or by others cash donations from non-Federal third parties.

(2) The value of third party in-kind contributions applicable to the period to which the cost sharing or matching requirements applies.

(b) *Qualifications and exceptions—*(1) *Costs borne by other Federal grant agreements.* Except as provided by Federal statute, a cost sharing or matching requirement may not be met by costs borne by another Federal grant. This prohibition does not apply to income earned by a grantee or subgrantee from a contract awarded under another Federal grant.

(2) *General revenue sharing.* For the purpose of this section, general revenue sharing funds distributed under 31 U.S.C. 6702 are not considered Federal grant funds.

(3) *Cost or contributions counted towards other Federal costs-sharing requirements.* Neither costs nor the values of third party in-kind contributions may count towards satisfying a cost sharing or matching requirement of a grant agreement if they have been or will be counted towards satisfying a cost sharing or matching requirement of another Federal grant agreement, a Federal procurement contract, or any other award of Federal funds.

(4) *Costs financed by program income.* Costs financed by program income, as defined in § \_\_\_\_ .25, shall not count towards satisfying a cost sharing or matching requirement unless they are expressly permitted in the terms of the assistance agreement. (This use of general program income is described in § \_\_\_\_ .25(g).)

(5) *Services or property financed by income earned by contractors.* Contractors under a grant may earn income from the activities carried out under the contract in addition to the amounts earned from the party awarding the contract. No costs of services or property supported by this income may count toward satisfying a cost sharing or matching requirement unless other provisions of the grant agreement expressly permit this kind of income to be used to meet the requirement.

(6) *Records.* Costs and third party in-kind contributions counting towards satisfying a cost sharing or matching requirement must be verifiable from the records of grantees and subgrantee or cost-type contractors. These records must show how the value placed on third party in-kind contributions was derived. To the extent feasible, volunteer services will be supported by the same methods that the organization uses to support the allocability of regular personnel costs.

(7) *Special standards for third party in-kind contributions.* (i) Third party in-kind contributions count towards satisfying a cost sharing or matching requirement only where, if the party receiving the contributions were to pay for them, the payments would be allowable costs.

(ii) Some third party in-kind contributions are goods and services that, if the grantee, subgrantee, or contractor receiving the contribution had to pay for

them, the payments would have been an indirect costs. Costs sharing or matching credit for such contributions shall be given only if the grantee, subgrantee, or contractor has established, along with its regular indirect cost rate, a special rate for allocating to individual projects or programs the value of the contributions.

(iii) A third party in-kind contribution to a fixed-price contract may count towards satisfying a cost sharing or matching requirement only if it results in:

(A) An increase in the services or property provided under the contract (without additional cost to the grantee or subgrantee) or

(B) A cost savings to the grantee or subgrantee.

(iv) The values placed on third party in-kind contributions for cost sharing or matching purposes will conform to the rules in the succeeding sections of this part. If a third party in-kind contribution is a type not treated in those sections, the value placed upon it shall be fair and reasonable.

(c) *Valuation of donated services*—(1) *Volunteer services.* Unpaid services provided to a grantee or subgrantee by individuals will be valued at rates consistent with those ordinarily paid for similar work in the grantee's or subgrantee's organization. If the grantee or subgrantee does not have employees performing similar work, the rates will be consistent with those ordinarily paid by other employers for similar work in the same labor market. In either case, a reasonable amount for fringe benefits may be included in the valuation.

(2) *Employees of other organizations.* When an employer other than a grantee, subgrantee, or cost-type contractor furnishes free of charge the services of an employee in the employee's normal line of work, the services will be valued at the employee's regular rate of pay exclusive of the employee's fringe benefits and overhead costs. If the services are in a different line of work, paragraph (c)(1) of this section applies.

(d) *Valuation of third party donated supplies and loaned equipment or space.* (1) If a third party donates supplies, the contribution will be valued at the market value of the supplies at the time of donation.

(2) If a third party donates the use of equipment or space in a building but retains title, the contribution will be valued at the fair rental rate of the equipment or space.

(e) *Valuation of third party donated equipment, buildings, and land.* If a third party donates equipment, buildings, or land, and title passes to a grantee or subgrantee, the treatment of the donated property will depend upon the purpose of the grant or subgrant, as follows:

(1) *Awards for capital expenditures.* If the purpose of the grant or subgrant is to assist the grantee or subgrantee in the acquisition of property, the market value of that property at the time of donation may be counted as cost sharing or matching.

(2) *Other awards.* If assisting in the acquisition of property is not the purpose of the grant or subgrant, paragraphs (e)(2)(i) and (ii) of this section apply:

(i) If approval is obtained from the awarding agency, the market value at the time of donation of the donated equipment or buildings and the fair rental rate of the donated land may be counted as cost sharing or matching. In the case of a subgrant, the terms of the grant agreement may require that the approval be obtained from the Federal agency as well as the grantee. In all

cases, the approval may be given only if a purchase of the equipment or rental of the land would be approved as an allowable direct cost. If any part of the donated property was acquired with Federal funds, only the non-federal share of the property may be counted as cost-sharing or matching.

(ii) If approval is not obtained under paragraph (e)(2)(i) of this section, no amount may be counted for donated land, and only depreciation or use allowances may be counted for donated equipment and buildings. The depreciation or use allowances for this property are not treated as third party in-kind contributions. Instead, they are treated as costs incurred by the grantee or subgrantee. They are computed and allocated (usually as indirect costs) in accordance with the cost principles specified in §\_\_\_\_.22, in the same way as depreciation or use allowances for purchased equipment and buildings. The amount of depreciation or use allowances for donated equipment and buildings is based on the property's market value at the time it was donated.

(f) *Valuation of grantee or subgrantee donated real property for construction/acquisition.* If a grantee or subgrantee donates real property for a construction or facilities acquisition project, the current market value of that property may be counted as cost sharing or matching. If any part of the donated property was acquired with Federal funds, only the non-federal share of the property may be counted as cost sharing or matching.

(g) *Appraisal of real property.* In some cases under paragraphs (d), (e) and (f) of this section, it will be necessary to establish the market value of land or a building or the fair rental rate of land or of space in a building. In these cases, the Federal agency may require the market value or fair rental value be set by an independent appraiser, and that the value or rate be certified by the grantee. This requirement will also be imposed by the grantee on subgrantees.

#### §\_\_\_\_.25 Program income.

(a) *General.* Grantees are encouraged to earn income to defray program costs. Program income includes income from fees for services performed, from the use or rental of real or personal property acquired with grant funds, from the sale of commodities or items fabricated under a grant agreement, and from payments of principal and interest on loans made with grant funds. Except as otherwise provided in regulations of the Federal agency, program income does not include interest on grant funds, rebates, credits, discounts, refunds, etc. and interest earned on any of them.

(b) *Definition of program income.* Program income means gross income received by the grantee or subgrantee directly generated by a grant supported activity, or earned only as a result of the grant agreement during the grant period. "During the grant period" is the time between the effective date of the award and the ending date of the award reflected in the final financial report.

(c) *Cost of generating program income.* If authorized by Federal regulations or the grant agreement, costs incident to the generation of program income may be deducted from gross income to determine program income.

(d) *Governmental revenues.* Taxes, special assessments, levies, fines, and other such revenues raised by a grantee or subgrantee are not program income unless the revenues are specifically identified in the grant agreement or Federal agency regulations as program income.

(e) *Royalties.* Income from royalties and license fees for copyrighted material, patents, and inventions developed by a grantee or subgrantee is program income only if the revenues are specifically identified in the grant agreement or Federal agency regulations as program income. (See §\_\_\_\_.34.)

(f) *Property.* Proceeds from the sale of real property or equipment will be handled in accordance with the requirements of §§\_\_\_\_.31 and \_\_\_\_\_.32.

(g) *Use of program income.* Program income shall be deducted from outlays which may be both Federal and non-Federal as described below, unless the Federal agency regulations or the grant agreement specify another alternative (or a combination of the alternatives). In specifying alternatives, the Federal agency may distinguish between income earned by the grantee and income earned by subgrantees and between the sources, kinds, or amounts of income. When Federal agencies authorize the alternatives in paragraphs (g)(2) and (3) of this section, program income in excess of any limits stipulated shall also be deducted from outlays.

(1) *Deduction.* Ordinarily program income shall be deducted from total allowable costs to determine the net allowable costs. Program income shall be used for current costs unless the Federal agency authorizes otherwise. Program income which the grantee did not anticipate at the time of the award shall be used to reduce the Federal agency and grantee contributions rather than to increase the funds committed to the project.

(2) *Addition.* When authorized, program income may be added to the funds committed to the grant agreement by the Federal agency and the grantee. The program income shall be used for the purposes and under the conditions of the grant agreement.

(3) *Cost sharing or matching.* When authorized, program income may be used to meet the cost sharing or matching requirement of the grant agreement. The amount of the Federal grant award remains the same.

(h) *Income after the award period.* There are no Federal requirements governing the disposition of program income earned after the end of the award period (i.e., until the ending date of the final financial report, see paragraph (a) of this section), unless the terms of the agreement or the Federal agency regulations provide otherwise.

#### §\_\_\_\_.26 Non-Federal audit.

(a) *Basic Rule.* Grantees and subgrantees are responsible for obtaining audits in accordance with the Single Audit Act of 1984 (31 U.S.C. 7501-7) and Federal agency implementing regulations. The audits shall be made by an independent auditor in accordance with generally accepted government auditing standards covering financial and compliance audits.

(b) *Subgrantees.* State or local governments, as those terms are defined for purposes of the Single Audit Act, that receive Federal financial assistance and provide \$25,000 or more of it in a fiscal year to a subgrantee shall:

(1) Determine whether State or local subgrantees have met the audit requirements of the Act and whether subgrantees covered by OMB Circular A-110, "Uniform Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations" have met the audit requirement. Commercial contractors (private for profit and private and governmental organizations) providing goods and services to State and local governments are not required to have a single audit performed. State and local governments should use their own procedures to ensure that the contractor has complied with laws and regulations affecting the expenditure of Federal funds;

(2) Determine whether the subgrantee spent Federal assistance funds provided in accordance with applicable laws and regulations. This may be accomplished by reviewing an audit of the subgrantee made in accordance with the Act, Circular A-110, or through other means (e.g., program reviews) if the subgrantee has not had such an audit;

(3) Ensure that appropriate corrective action is taken within six months after receipt of the audit report in instance of noncompliance with Federal laws and regulations;

(4) Consider whether subgrantee audits necessitate adjustment of the grantee's own records; and

(5) Require each subgrantee to permit independent auditors to have access to the records and financial statements.

(c) *Auditor selection.* In arranging for audit services, §\_\_\_\_.36 shall be followed.

### **Changes, Property, and Subawards**

#### **§\_\_\_\_.30 Changes.**

(a) *General.* Grantees and subgrantees are permitted to rebudget within the approved direct cost budget to meet unanticipated requirements and may make limited program changes to the approved project. However, unless waived by the awarding agency, certain types of post-award changes in budgets and projects shall require the prior written approval of the awarding agency.

(b) *Relation to cost principles.* The applicable cost principles (see §\_\_\_\_.22) contain requirements for prior approval of certain types of costs. Except where waived, those requirements apply to all grants and subgrants even if paragraphs (c) through (f) of this section do not.

(c) *Budget changes.* (1) *Nonconstruction projects.* Except as stated in other regulations or an award document, grantees or subgrantees shall obtain the prior approval of the awarding agency whenever any of the following changes is anticipated under a nonconstruction award:

(i) Any revision which would result in the need for additional funding.

(ii) Unless waived by the awarding agency, cumulative transfers among direct cost categories, or, if applicable, among separately budgeted programs, projects, functions, or activities which exceed or are expected to exceed ten percent of the current total approved budget, whenever the awarding agency's share exceeds \$100,000.

(iii) Transfer of funds allotted for training allowances (i.e., from direct payments to trainees to other expense categories).

(2) *Construction projects.* Grantees and subgrantees shall obtain prior written approval for any budget revision which would result in the need for additional funds.

(3) *Combined construction and nonconstruction projects.* When a grant or subgrant provides funding for both construction and nonconstruction activities, the grantee or subgrantee must obtain prior written approval from the awarding agency before making any fund or budget transfer from nonconstruction to construction or vice versa.

(d) *Programmatic changes.* Grantees or subgrantees must obtain the prior approval of the awarding agency whenever any of the following actions is anticipated:



(1) Any revision of the scope or objectives of the project (regardless of whether there is an associated budget revision requiring prior approval).

(2) Need to extend the period of availability of funds.

(3) Changes in key persons in cases where specified in an application or a grant award. In research projects, a change in the project director or principal investigator shall always require approval unless waived by the awarding agency.

(4) Under nonconstruction projects, contracting out, subgranting (if authorized by law) or otherwise obtaining the services of a third party to perform activities which are central to the purposes of the award. This approval requirement is in addition to the approval requirements of §\_\_\_\_.36 but does not apply to the procurement of equipment, supplies, and general support services.

(e) *Additional prior approval requirements.* The awarding agency may not require prior approval for any budget revision which is not described in paragraph (c) of this section.

(f) *Requesting prior approval.* (1) A request for prior approval of any budget revision will be in the same budget format the grantee used in its application and shall be accompanied by a narrative justification for the proposed revision.

(2) A request for a prior approval under the applicable Federal cost principles (see §\_\_\_\_.22) may be made by letter.

(3) A request by a subgrantee for prior approval will be addressed in writing to the grantee. The grantee will promptly review such request and shall approve or disapprove the request in writing. A grantee will not approve any budget or project revision which is inconsistent with the purpose or terms and conditions of the Federal grant to the grantee. If the revision, requested by the subgrantee would result in a change to the grantee's approved project which requires Federal prior approval, the grantee will obtain the Federal agency's approval before approving the subgrantee's request.

### **§\_\_\_\_.31 Real property.**

(a) *Title.* Subject to the obligations and conditions set forth in this section, title to real property acquired under a grant or subgrant will vest upon acquisition in the grantee or subgrantee respectively.

(b) *Use.* Except as otherwise provided by Federal statutes, real property will be used for the originally authorized purposes as long as needed for that purposes, and the grantee or subgrantee shall not dispose of or encumber its title or other interests.

(c) *Disposition.* When real property is no longer needed for the originally authorized purpose, the grantee or subgrantee will request disposition instructions from the awarding agency. The instructions will provide for one of the following alternatives:

(1) *Retention of title.* Retain title after compensating the awarding agency. The amount paid to the awarding agency will be computed by applying the awarding agency's percentage of participation in the cost of the original purchase to the fair market value of the property. However, in those situations where a grantee or subgrantee is disposing of real property acquired with grant funds and acquiring replacement real property under the same program, the net proceeds from the disposition may be used as an offset to the cost of the replacement property.

(2) *Sale of property.* Sell the property and compensate the awarding agency. The amount due to the awarding agency will be calculated by applying the awarding agency's percentage of participation in the cost of the original purchase to the proceeds of the sale after deduction of any actual and reasonable selling and fixing-up expenses. If the grant is still active, the net proceeds from sale may be offset against the original cost of the property. When a grantee or subgrantee is directed to sell property, sales procedures shall be followed that provide for competition to the extent practicable and result in the highest possible return.

(3) *Transfer of title.* Transfer title to the awarding agency or to a third-party designated/approved by the awarding agency. The grantee or subgrantee shall be paid an amount calculated by applying the grantee or subgrantee's percentage of participation in the purchase of the real property to the current fair market value of the property.

#### **§ \_\_\_\_ .32 Equipment.**

(a) *Title.* Subject to the obligations and conditions set forth in this section, title to equipment acquired under a grant or subgrant will vest upon acquisition in the grantee or subgrantee respectively.

(b) *States.* A State will use, manage, and dispose of equipment acquired under a grant by the State in accordance with State laws and procedures. Other grantees and subgrantees will follow paragraphs (c) through (e) of this section.

(c) *Use.* (1) Equipment shall be used by the grantee or subgrantee in the program or project for which it was acquired as long as needed, whether or not the project or program continues to be supported by Federal funds. When no longer needed for the original program or project, the equipment may be used in other activities currently or previously supported by a Federal agency.

(2) The grantee or subgrantee shall also make equipment available for use on other projects or programs currently or previously supported by the Federal Government, providing such use will not interfere with the work on the projects or program for which it was originally acquired. First preference for other use shall be given to other programs or projects supported by the awarding agency. User fees should be considered if appropriate.

(3) Notwithstanding the encouragement in § \_\_\_\_ .25(a) to earn program income, the grantee or subgrantee must not use equipment acquired with grant funds to provide services for a fee to compete unfairly with private companies that provide equivalent services, unless specifically permitted or contemplated by Federal statute.

(4) When acquiring replacement equipment, the grantee or subgrantee may use the equipment to be replaced as a trade-in or sell the property and use the proceeds to offset the cost of the replacement property, subject to the approval of the awarding agency.

(d) *Management requirements.* Procedures for managing equipment (including replacement equipment), whether acquired in whole or in part with grant funds, until disposition takes place will, as a minimum, meet the following requirements:

(1) Property records must be maintained that include a description of the property, a serial number or other identification number, the source of property, who holds title, the acquisition date, and cost of the property, percentage of Federal participation in the cost of the property, the location, use and condition of the property, and any ultimate disposition data including the date of disposal and sale price of the property.

(2) A physical inventory of the property must be taken and the results reconciled with the property records at least once every two years.

(3) A control system must be developed to ensure adequate safeguards to prevent loss, damage, or theft of the property. Any loss, damage, or theft shall be investigated.

(4) Adequate maintenance procedures must be developed to keep the property in good condition.

(5) If the grantee or subgrantee is authorized or required to sell the property, proper sales procedures must be established to ensure the highest possible return.

(e) *Disposition.* When original or replacement equipment acquired under a grant or subgrant is no longer needed for the original project or program or for other activities currently or previously supported by a Federal agency, disposition of the equipment will be made as follows:

(1) Items of equipment with a current per-unit fair market value of less than \$5,000 may be retained, sold or otherwise disposed of with no further obligation to the awarding agency.

(2) Items of equipment with a current per unit fair market value in excess of \$5,000 may be retained or sold and the awarding agency shall have a right to an amount calculated by multiplying the current market value or proceeds from sale by the awarding agency's share of the equipment.

(3) In cases where a grantee or subgrantee fails to take appropriate disposition actions, the awarding agency may direct the grantee or subgrantee to take excess and disposition actions.

(f) *Federal equipment.* In the event a grantee or subgrantee is provided federally-owned equipment:

(1) Title will remain vested in the Federal Government.

(2) Grantees or subgrantees will manage the equipment in accordance with Federal agency rules and procedures, and submit an annual inventory listing.

(3) When the equipment is no longer needed, the grantee or subgrantee will request disposition instructions from the Federal agency.

(g) *Right to transfer title.* The Federal awarding agency may reserve the right to transfer title to the Federal Government or a third party named by the awarding agency when such a third party is otherwise eligible under existing statutes. Such transfers shall be subject to the following standards:

(1) The property shall be identified in the grant or otherwise made known to the grantee in writing.

(2) The Federal awarding agency shall issue disposition instruction within 120 calendar days after the end of the Federal support of the project for which it was acquired. If the Federal awarding agency fails to issue disposition instructions within the 120 calendar-day period the grantee shall follow §\_\_\_\_.32(e).

(3) When title to equipment is transferred, the grantee shall be paid an amount calculated by applying the percentage of participation in the purchase to the current fair market value of the property.

### **§\_\_\_\_.33 Supplies.**

(a) *Title.* Title to supplies acquired under a grant or subgrant will vest, upon acquisition, in the grantee or subgrantee respectively.

(b) *Disposition.* If there is a residual inventory of unused supplies exceeding \$5,000 in total aggregate fair market value upon termination or completion of the award, and if the supplies are not needed for any other federally sponsored programs or projects, the grantee or subgrantee shall compensate the awarding agency for its share.

#### **§ \_\_\_\_ .34 Copyrights.**

The Federal awarding agency reserves a royalty-free, nonexclusive, and irrevocable license to reproduce, publish or otherwise use, and to authorize others to use, for Federal Government purposes:

(a) The copyright in any work developed under a grant, subgrant, or contract under a grant or subgrant; and

(b) Any rights of copyright to which a grantee, subgrantee or a contractor purchases ownership with grant support.

#### **§ \_\_\_\_ .35 Subawards to debarred and suspended parties.**

Grantees and subgrantees must not make any award or permit any award (subgrant or contract) at any tier to any party which is debarred or suspended or is otherwise excluded from or ineligible for participation in Federal assistance programs under Executive Order 12549, "Debarment and Suspension."

#### **§ \_\_\_\_ .36 Procurement.**

(a) *States.* When procuring property and services under a grant, a State will follow the same policies and procedures it uses for procurements from its non-Federal funds. The State will ensure that every purchase order or other contract includes any clauses required by Federal statutes and executive orders and their implementing regulations. Other grantees and subgrantees will follow paragraphs (b) through (i) in this section.

(b) *Procurement standards.* (1) Grantees and subgrantees will use their own procurement procedures which reflect applicable State and local laws and regulations, provided that the procurements conform to applicable Federal law and the standards identified in this section.

(2) Grantees and subgrantees will maintain a contract administration system which ensures that contractors perform in accordance with the terms, conditions, and specifications of their contracts or purchase orders.

(3) Grantees and subgrantees will maintain a written code of standards of conduct governing the performance of their employees engaged in the award and administration of contracts. No employee, officer or agent of the grantee or subgrantee shall participate in selection, or in the award or administration of a contract supported by Federal funds if a conflict of interest, real or apparent, would be involved. Such a conflict would arise when:

- (i) The employee, officer or agent,
- (ii) Any member of his immediate family,
- (iii) His or her partner, or

(iv) An organization which employs, or is about to employ, any of the above, has a financial or other interest in the firm selected for award. The grantee's or subgrantee's officers, employees or agents will neither solicit nor accept gratuities, favors or anything of monetary value from contractors, potential contractors, or parties to subagreements. Grantees and subgrantees may set minimum rules where the financial interest is not substantial or the gift is an unsolicited item of nominal intrinsic value. To the extent permitted

by State or local law or regulations, such standards or conduct will provide for penalties, sanctions or other disciplinary actions for violations of such standards by the grantee's and subgrantee's officers, employees, or agents, or by contractors or their agents. The awarding agency may in regulation provide additional prohibitions relative to real, apparent, or potential conflicts of interest.

(4) Grantee and subgrantee procedures will provide for a review of proposed procurements to avoid purchase of unnecessary or duplicative items. Consideration should be given to consolidating or breaking out procurements to obtain a more economical purchase. Where appropriate, an analysis will be made of lease versus purchase alternatives, and any other appropriate analysis to determine the most economical approach.

(5) To foster greater economy and efficiency, grantees and subgrantees are encouraged to enter into State and local intergovernmental agreements for procurement or use of common goods and services.

(6) Grantees and subgrantees are encouraged to use Federal excess and surplus property in lieu of purchasing new equipment and property whenever such use is feasible and reduces project costs.

(7) Grantees and subgrantees are encouraged to use value engineering clauses in contracts for construction projects of sufficient size to offer reasonable opportunities for cost reductions. Value engineering is a systematic and creative analysis of each contract item or task to ensure that its essential function is provided at the overall lower cost.

(8) Grantees and subgrantees will make awards only to responsible contractors possessing the ability to perform successfully under the terms and conditions of a proposed procurement. Consideration will be given to such matters as contractor integrity, compliance with public policy, record of past performance, and financial and technical resources.

(9) Grantees and subgrantees will maintain records sufficient to detail the significant history of a procurement. These records will include, but are not necessarily limited to the following: rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis for the contract price.

(10) Grantees and subgrantees will use time and material type contracts only—

(i) After a determination that no other contract is suitable, and

(ii) If the contract includes a ceiling price that the contractor exceeds at its own risk.

(11) Grantees and subgrantees alone will be responsible, in accordance with good administrative practice and sound business judgment, for the settlement of all contractual and administrative issues arising out of procurements. These issues include, but are not limited to source evaluation, protests, disputes, and claims. These standards do not relieve the grantee or subgrantee of any contractual responsibilities under its contracts. Federal agencies will not substitute their judgment for that of the grantee or subgrantee unless the matter is primarily a Federal concern. Violations of law will be referred to the local, State or Federal authority having proper jurisdiction.

(12) Grantees and subgrantees will have protest procedures to handle and resolve disputes relating to their procurements and shall in all instances disclose information regarding the protest to the awarding agency. A protestor

must exhaust all administrative remedies with the grantee and subgrantee before pursuing a protest with the Federal agency. Reviews of protests by the Federal agency will be limited to:

(i) Violations of Federal law or regulations and the standards of this section (violations of State or local law will be under the jurisdiction of State or local authorities) and

(ii) Violations of the grantee's or subgrantee's protest procedures for failure to review a complaint or protest. Protests received by the Federal agency other than those specified above will be referred to the grantee or subgrantee.

(c) *Competition.* (1) All procurement transactions will be conducted in a manner providing full and open competition consistent with the standards of §\_\_\_\_.36. Some of the situations considered to be restrictive of competition include but are not limited to:

(i) Placing unreasonable requirements on firms in order for them to qualify to do business,

(ii) Requiring unnecessary experience and excessive bonding,

(iii) Noncompetitive pricing practices between firms or between affiliated companies,

(iv) Noncompetitive awards to consultants that are on retainer contracts,

(v) Organizational conflicts of interest,

(vi) Specifying only a "brand name" product instead of allowing "an equal" product to be offered and describing the performance of other relevant requirements of the procurement, and

(vii) Any arbitrary action in the procurement process.

(2) Grantees and subgrantees will conduct procurements in a manner that prohibits the use of statutorily or administratively imposed in-State or local geographical preferences in the evaluation of bids or proposals, except in those cases where applicable Federal statutes expressly mandate or encourage geographic preference. Nothing in this section preempts State licensing laws. When contracting for architectural and engineering (A/E) services, geographic location may be a selection criteria provided its application leaves an appropriate number of qualified firms, given the nature and size of the project, to compete for the contract.

(3) Grantees will have written selection procedures for procurement transactions. These procedures will ensure that all solicitations:

(i) Incorporate a clear and accurate description of the technical requirements for the material, product, or service to be procured. Such description shall not, in competitive procurements, contain features which unduly restrict competition. The description may include a statement of the qualitative nature of the material, product or service to be procured, and when necessary, shall set forth those minimum essential characteristics and standards to which it must conform if it is to satisfy its intended use. Detailed product specifications should be avoided if at all possible. When it is impractical or uneconomical to make a clear and accurate description of the technical requirements, a "brand name or equal" description may be used as a means to define the performance or other salient requirements of a procurement. The specific features of the named brand which must be met by offerors shall be clearly stated; and

(ii) Identify all requirements which the offerors must fulfill and all other factors to be used in evaluating bids or proposals.

(4) Grantees and subgrantees will ensure that all prequalified lists of persons, firms, or products which are used in acquiring goods and services are current and include enough qualified sources to ensure maximum open and free competition. Also, grantees and subgrantees will not preclude potential bidders from qualifying during the solicitation period.

(d) *Methods of procurement to be followed.* (1) Procurement by *small purchase procedures*. Small purchase procedures are those relatively simple and informal procurement methods for securing services, supplies, or other property that do not cost more than \$25,000 in the aggregate. If small purchase procurements are used, price or rate quotations will be obtained from an adequate number of qualified sources.

(2) *Procurement by sealed bids* (formal advertising). Bids are publicly solicited and a firm-fixed price contract (lump sum or unit price), is awarded to the responsible bidder whose bid, conforming with all the material terms and conditions of the invitation for bids, is the lowest in price. The sealed bid method is the preferred method for procuring construction, if the conditions in §\_\_\_\_.36(d) (2)(i) apply.

(i) In order for sealed bidding to be feasible, the following conditions should be present:

(A) A complete, adequate, and realistic specification or purchase description is available;

(B) Two or more responsible bidders are willing and able to compete effectively for the business; and

(C) The procurement lends itself to a firm fixed price contract and the selection of the successful bidder can be made principally on the basis of price.

(ii) If sealed bids are used, the following requirements apply:

(A) The invitation for bids will be publicly advertised and bids shall be solicited from an adequate number of known suppliers, providing them sufficient time prior to the date set for opening the bids;

(B) The invitation for bids, which will include any specifications and pertinent attachments, shall define the items or services in order for the bidder to properly respond;

(C) All bids will be publicly opened at the time and place prescribed in the invitation for bids;

(D) A firm fixed-price contract award will be made in writing to the lowest responsive and responsible bidder. Where specified in bidding documents, factors such as discounts, transportation cost, and life cycle costs shall be considered in determining which bid is lowest. Payment discounts will only be used to determine the low bid when prior experience indicates that such discounts are usually taken advantage of; and

(E) Any or all bids may be rejected if there is a sound documented reason.

(3) Procurement by *competitive proposals*. The technique of competitive proposals is normally conducted with more than one source submitting an offer, and either a fixed-price or cost-reimbursement type contract is awarded. It is generally used when conditions are not appropriate for the use of sealed bids. If this method is used, the following requirements apply:

(i) Requests for proposals will be publicized and identify all evaluation factors and their relative importance: Any response to publicized requests for proposals shall be honored to the maximum extent practical;

(ii) Proposals will be solicited from an adequate number of qualified sources;

(iii) Grantees and subgrantees will have a method for conducting technical evaluations of the proposals received and for selecting awardees;

(iv) Awards will be made to the responsible firm whose proposal is most advantageous to the program, with price and other factors considered; and

(v) Grantees and subgrantees may use competitive proposal procedures for qualifications-based procurement of architectural/engineering (A/E) professional services whereby competitors' qualifications are evaluated and the most qualified competitor is selected, subject to negotiation of fair and reasonable compensation. The method, where price is not used as a selection factor, can only be used in procurement of A/E professional services. It cannot be used to purchase other types of services though A/E firms are a potential source to perform the proposed effort.

(4) Procurement by *noncompetitive proposals* is procurement through solicitation of a proposal from only one source, or after solicitation of a number of sources, competition is determined inadequate.

(i) Procurement by noncompetitive proposals may be used only when the award of a contract is infeasible under small purchase procedures, sealed bids or competitive proposals and one of the following circumstances applies:

(A) The item is available only from a single source;

(B) The public exigency or emergency for the requirement will not permit a delay resulting from competitive solicitation.

(C) The awarding agency authorizes noncompetitive proposals; or

(D) After solicitation of a number of sources, competition is determined inadequate.

(ii) Cost analysis, i.e., verifying the proposed cost data, the projections of the data, and the evaluation of the specific elements of costs and profit, is required.

(iii) Grantees and subgrantees may be required to submit the proposed procurement to the awarding agency for pre-award review in accordance with paragraph (g) of this section.

(e) *Contracting with small and minority firms, women's business enterprise and labor surplus area firms.* (1) The grantee and subgrantee will take all necessary affirmative steps to assure that minority firms, women's business enterprises, and labor surplus area firms are used when possible.

(2) Affirmative steps shall include:

(i) Placing qualified small and minority businesses and women's business enterprises on solicitation lists;

(ii) Assuring that small and minority businesses, and women's business enterprises are solicited whenever they are potential sources;

(iii) Dividing total requirements, when economically feasible, into smaller tasks or quantities to permit maximum participation by small and minority business, and women's business enterprises;



(iv) Establishing delivery schedules, where the requirement permits, which encourage participation by small and minority business, and women's business enterprises;

(v) Using the services and assistance of the Small Business Administration, and the Minority Business Development Agency of the Department of Commerce; and

(vi) Requiring the prime contractor, if subcontracts are to be let, to take the affirmative steps listed in paragraphs (e)(2)(i) through (v) of this section.

(f) *Contract cost and price.* (1) Grantees and subgrantees must perform a cost or price analysis in connection with every procurement action including contract modifications. The method and degree of analysis is dependent on the facts surrounding the particular procurement situation, but as a starting point, grantees must make independent estimates before receiving bids or proposals. A cost analysis must be performed when the offeror is required to submit the elements of his estimated cost, e.g., under professional, consulting, and architectural engineering services contracts. A cost analysis will be necessary when adequate price competition is lacking, and for sole source procurements, including contract modifications or change orders, unless price reasonableness can be established on the basis of a catalog or market price of a commercial product sold in substantial quantities to the general public or based on prices set by law or regulation. A price analysis will be used in all other instances to determine the reasonableness of the proposed contract price.

(2) Grantees and subgrantees will negotiate profit as a separate element of the price for each contract in which there is no price competition and in all cases where cost analysis is performed. To establish a fair and reasonable profit, consideration will be given to the complexity of the work to be performed, the risk borne by the contractor, the contractor's investment, the amount of subcontracting, the quality of its record of past performance, and industry profit rates in the surrounding geographical area for similar work.

(3) Costs or prices based on estimated costs for contracts under grants will be allowable only to the extent that costs incurred or cost estimates included in negotiated prices are consistent with Federal cost principles (see §\_\_\_\_.22). Grantees may reference their own cost principles that comply with the applicable Federal cost principles.

(4) The cost plus a percentage of cost and percentage of construction cost methods of contracting shall not be used.

(g) *Awarding agency review.* (1) Grantees and subgrantees must make available, upon request of the awarding agency, technical specifications on proposed procurements where the awarding agency believes such review is needed to ensure that the item and/or service specified is the one being proposed for purchase. This review generally will take place prior to the time the specification is incorporated into a solicitation document. However, if the grantee or subgrantee desires to have the review accomplished after a solicitation has been developed, the awarding agency may still review the specifications, with such review usually limited to the technical aspects of the proposed purchase.

(2) Grantees and subgrantees must on request make available for awarding agency pre-award review [delete “,”] procurement documents, such as requests for proposals or invitations for bids, independent cost estimates, etc., when:

(i) A grantee's or subgrantee's procurement procedures or operation fails to comply with the procurement standards in this section; or

(ii) The procurement is expected to exceed \$25,000 and is to be awarded without competition or only one bid or offer is received in response to a solicitation; or

(iii) The procurement, which is expected to exceed \$25,000, specifies a "brand name" product; or

(iv) The proposed award over \$25,000 is to be awarded to other than the apparent low bidder under a sealed bid procurement; or

(v) A proposed contract modification changes the scope of a contract or increases the contract amount by more than \$25,000.

(3) A grantee or subgrantee will be exempt from the pre-award review in paragraph (g)(2) of this section if the awarding agency determines that its procurement systems comply with the standards of this section.

(i) A grantee or subgrantee may request that its procurement system be reviewed by the awarding agency to determine whether its system meets these standards in order for its system to be certified. Generally, these reviews shall occur where there is a continuous high-dollar funding, and third-party contracts are awarded on a regular basis;

(ii) A grantee or subgrantee may self-certify its procurement system. Such self-certification shall not limit the awarding agency's right to survey the system. Under a self-certification procedure, awarding agencies may wish to rely on written assurances from the grantee or subgrantee that it is complying with these standards. A grantee or subgrantee will cite specific procedures, regulations, standards, etc., as being in compliance with these requirements and have its system available for review.

(h) *Bonding requirements.* For construction or facility improvement contracts or subcontracts exceeding \$100,000, the awarding agency may accept the bonding policy and requirements of the grantee or subgrantee provided the awarding agency has made a determination that the awarding agency's interest is adequately protected. If such a determination has not been made, the minimum requirements shall be as follows:

(1) *A bid guarantee from each bidder equivalent to five percent of the bid price.* The "bid guarantee" shall consist of a firm commitment such as a bid bond, certified check, or other negotiable instrument accompanying a bid as assurance that the bidder will, upon acceptance of his bid, execute such contractual documents as may be required within the time specified.

(2) *A performance bond on the part of the contractor for 100 percent of the contract price.* A "performance bond" is one executed in connection with a contract to secure fulfillment of all the contractor's obligations under such contract.

(3) *A payment bond on the part of the contractor for 100 percent of the contract price.* A "payment bond" is one executed in connection with a contract to assure payment as required by law of all persons supplying labor and material in the execution of the work provided for in the contract.

(i) *Contract provisions.* A grantee's and subgrantee's contracts must contain provisions in paragraph (i) of this Section. Federal agencies are permitted to require changes, remedies, changed conditions, access and records retention, suspension of work, and other clauses approved by the Office of Procurement Policy.

(1) Administrative, contractual, or legal remedies in instances where contractors violate or breach contract terms, and provide for such sanctions and penalties as may be appropriate. (Contracts other than small purchases)

(2) Termination for cause and for convenience by the grantee or subgrantee including the manner by which it will be effected and the basis for settlement. (All contracts in the excess of \$10,000)

(3) Compliance with Executive Order 11246 of September 24, 1965 entitled "Equal Employment Opportunity," as amended by Executive Order 11375 of October 13, 1967 and as supplemented in Department of Labor regulations (41 CFR Part 60). (All construction contracts awarded in excess of \$10,000 by grantees and their contractors or subgrantees)

(4) Compliance with the Copeland "Anti-Kickback" Act (18 U.S.C. 874) as supplemented in Department of Labor regulations (29 CFR Part 3). (All contracts and subgrants for construction or repair)

(5) Compliance with the Davis-Bacon Act (40 U.S.C. 276a to a-7) as supplemented by Department of Labor regulations (29 CFR Part 5). (Construction contracts in excess of \$2,000 awarded by grantees and subgrantees when required by Federal grant program legislation)

(6) Compliance with Sections 103 and 107 of the Contract Work Hours and Safety Standards Act (40 U.S.C. 327-330) as supplemented by Department of Labor regulations (29 CFR Part 5). (Construction contracts awarded by grantees and subgrantees in excess of \$2,000, and in excess of \$2,500 for other contracts which involve the employment of mechanics or laborers)

(7) Notice of awarding agency requirements and regulations pertaining to reporting.

(8) Notice of awarding agency requirements and regulations pertaining to patent rights with respect to any discovery or invention which arises or is developed in course of or under such contract.

(9) Awarding agency requirements and regulations pertaining to copyrights and rights in data.

(10) Access by the grantee, the subgrantee, the Federal grantor agency, the Comptroller General of the United States, or any of their duly authorized representatives to any books, documents, papers, and records of the contractor which are directly pertinent to that specific contract for the purpose of making audit, examination, excerpts, and transcriptions.

(11) Retention of all required records for three years after grantees or subgrantees make final payments and all other pending matters are closed.

(12) Compliance with all applicable standards, orders, or requirements issued under section 306 of the Clean Air Act (42 U.S.C. 1857(h)), section 508 of the Clean Water Act (33 U.S.C. 1368), Executive Order 11738, and Environmental Protection Agency regulations (40 CFR Part 15). (Contracts, subcontracts, and subgrants of amounts in excess of \$100,000)

(13) Mandatory standards and policies relating to energy efficiency which are contained in the state energy conservation plan issued in compliance with the Energy Policy and Conservation Act (Pub. L. 94-163).

#### **§ \_\_\_\_ .37 Subgrants.**

(a) *States.* States shall follow state law and procedures when awarding and administering subgrants (whether on a cost reimbursement or fixed amount basis) of financial assistance to local and Indian tribal governments. States shall:

(1) Ensure that every subgrant includes any clauses required by Federal statute and executive orders and their implementing regulations;

(2) Ensure that subgrantees are aware of requirements imposed upon them by Federal statute and regulation;

(3) Ensure that a provision for compliance with Section \_\_\_\_\_.42 is placed in every cost reimbursement subgrant; and

(4) Conform any advances of grant funds to subgrantees substantially to the same standards of timing and amount that apply to cash advances by Federal agencies.

(b) *All other grantees.* All other grantees shall follow the provisions of this part which are applicable to awarding agencies when awarding and administering subgrants (whether on a cost reimbursement or fixed amount basis) of financial assistance to local and Indian tribal governments. Grantees shall:

(1) Ensure that every subgrant includes a provision for compliance with this part;

(2) Ensure that every subgrant includes any clauses required by Federal statute and executive orders and their implementing regulations; and

(3) Ensure that subgrantees are aware of requirements imposed upon them by Federal statutes and regulations.

(c) *Exceptions.* By their own terms, certain provisions of this part do not apply to the award and administration of subgrants:

(1) Section \_\_\_\_\_.10;

(2) Section \_\_\_\_\_.11;

(3) The letter-of-credit procedures specified in Treasury Regulations at 31 CFR Part 205, cited in § \_\_\_\_\_.21; and

(4) Section \_\_\_\_\_.50.

### **Reports, Records, Retention, and Enforcement**

#### **§ \_\_\_\_\_.40 Monitoring and reporting program performance.**

(a) *Monitoring by grantees.* Grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

(b) *Nonconstruction performance reports.* The Federal agency may, if it decides that performance information available from subsequent applications contains sufficient information to meet its programmatic needs, require the grantee to submit a performance report only upon expiration or termination of grant support. Unless waived by the Federal agency this report will be due on the same date as the final Financial Status Report.

(1) Grantees shall submit annual performance reports unless the awarding agency requires quarterly or semi-annual reports. However, performance reports will not be required more frequently than quarterly. Annual reports shall be due 90 days after the grant year, quarterly or semi-annual reports shall be due 30 days after the reporting period. The final performance report will be due 90 days after the expiration or termination of grant support. If a justified request is submitted by a grantee, the Federal agency may extend the due date for any performance report. Additionally, requirements for unnecessary performance reports may be waived by the Federal agency.

(2) Performance reports will contain, for each grant, brief information on the following:

(i) A comparison of actual accomplishments to the objectives established for the period. Where the output of the project can be quantified, a computation of the cost per unit of output may be required if that information will be useful.

(ii) The reasons for slippage if established objectives were not met.

(iii) Additional pertinent information including, when appropriate, analysis and explanation of cost overruns or high unit costs.

(3) Grantees will not be required to submit more than the original and two copies of performance reports.

(4) Grantees will adhere to the standards in this section in prescribing performance reporting requirements for subgrantees.

(c) *Construction performance reports.* For the most part, on-site technical inspections and certified percentage-of-completion data are relied on heavily by Federal agencies to monitor progress under construction grants and subgrants. The Federal agency will require additional formal performance reports only when considered necessary, and never more frequently than quarterly.

(d) *Significant developments.* Events may occur between the scheduled performance reporting dates which have significant impact upon the grant or subgrant supported activity. In such cases, the grantee must inform the Federal agency as soon as the following types of conditions become known:

(1) Problems, delays, or adverse conditions which will materially impair the ability to meet the objective of the award. This disclosure must include a statement of the action taken, or contemplated, and any assistance needed to resolve the situation.

(2) Favorable developments which enable meeting time schedules and objectives sooner or at less cost than anticipated or producing more beneficial results than originally planned.

(e) Federal agencies may make site visits as warranted by program needs.

(f) *Waivers, extensions.* (1) Federal agencies may waive any performance report required by this part if not needed.

(2) The grantee may waive any performance report from a subgrantee when not needed. The grantee may extend the due date for any performance report from a subgrantee if the grantee will still be able to meet its performance reporting obligations to the Federal agency.

#### **§ \_\_\_\_ .41 Financial Reporting.**

(a) *General.* (1) Except as provided in paragraphs (a)(2) and (5) of this section, grantees will use only the forms specified in paragraphs (a) through (e) of this section, and such supplementary or other forms as may from time to time be authorized by OMB, for:

(i) Submitting financial reports to Federal agencies, or

(ii) Requesting advances or reimbursements when letters of credit are not used.

(2) Grantees need not apply the forms prescribed in this section in dealing with their subgrantees. However, grantees shall not impose more burdensome requirements on subgrantees.

(3) Grantees shall follow all applicable standard and supplemental Federal agency instructions approved by OMB to the extent required under the Paperwork Reduction Act of 1980 for use in connection with forms specified in paragraphs (b) through (e) of this section. Federal agencies may issue substantive supplementary instructions only with the approval of OMB. Federal agencies may shade out or instruct the grantee to disregard any line item that the Federal agency finds unnecessary for its decisionmaking purposes.

(4) Grantees will not be required to submit more than the original and two copies of forms required under this part.

(5) Federal agencies may provide computer outputs to grantees to expedite or contribute to the accuracy of reporting. Federal agencies may accept the required information from grantees in machine usable format or computer printouts instead of prescribed forms.

(6) Federal agencies may waive any report required by this section if not needed.

(7) Federal agencies may extend the due date of any financial report upon receiving a justified request from a grantee.

(b) *Financial Status Report.*—(1) *Form.* Grantees will use Standard Form 269 or 269A, Financial Status Report, to report the status of funds for all nonconstruction grants and for construction grants when required in accordance with paragraph §\_\_\_\_.41(e)(2)(iii) of this section.

(2) *Accounting basis.* Each grantee will report program outlays and program income on a cash or accrual basis as prescribed by the awarding agency. If the Federal agency requires accrual information and the grantee's accounting records are not normally kept on the accrual basis, the grantee shall not be required to convert its accounting system but shall develop such accrual information through and analysis of the documentation on hand.

(3) *Frequency.* The Federal agency may prescribe the frequency of the report for each project or program. However, the report will not be required more frequently than quarterly. If the Federal agency does not specify the frequency of the report, it will be submitted annually. A final report will be required upon expiration or termination of grant support.

(4) *Due date.* When reports are required on a quarterly or semiannual basis, they will be due 30 days after the reporting period. When required on an annual basis, they will be due 90 days after the grant year. Final reports will be due 90 days after the expiration or termination of grant support.

(c) *Federal Cash Transactions Report.*—(1) *Form.* (i) For grants paid by letter or credit, Treasury check advances or electronic transfer of funds, the grantee will submit the Standard Form 272, Federal Cash Transactions Report, and when necessary, its continuation sheet, Standard Form 272a, unless the terms of the award exempt the grantee from this requirement.

(ii) These reports will be used by the Federal agency to monitor cash advanced to grantees and to obtain disbursement or outlay information for each grant from grantees. The format of the report may be adapted as appropriate when reporting is to be accomplished with the assistance of automatic data processing equipment provided that the information to be submitted is not changed in substance.

(2) *Forecasts of Federal cash requirements.* Forecasts of Federal cash requirements may be required in the "Remarks" section of the report.

(3) *Cash in hands of subgrantees.* When considered necessary and feasible by the Federal agency, grantees may be required to report the amount of cash advances in excess of three days' needs in the hands of their subgrantees or contractors and to provide short narrative explanations of actions taken by the grantee to reduce the excess balances.

(4) *Frequency and due date.* Grantees must submit the report no later than 15 working days following the end of each quarter. However, where an advance either by letter of credit or electronic transfer of funds is authorized at an annualized rate of one million dollars or more, the Federal agency may require the report to be submitted within 15 working days following the end of each month.

(d) *Request for advance or reimbursement*—(1) *Advance payments.* Requests for Treasury check advance payments will be submitted on Standard Form 270, Request for Advance or Reimbursement. (This form will not be used for drawdowns under a letter of credit, electronic funds transfer or when Treasury check advance payments are made to the grantee automatically on a predetermined basis.)

(2) *Reimbursements.* Requests for reimbursement under nonconstruction grants will also be submitted on Standard Form 270. (For reimbursement requests under construction grants, see paragraph (e)(1) of this section.)

(3) The frequency for submitting payment requests is treated in §\_\_\_\_.41(b)(3).

(e) *Outlay report and request for reimbursement for construction programs.* (1) Grants that support construction activities paid by reimbursement method.

(i) Requests for reimbursement under construction grants will be submitted on Standard Form 271, Outlay Report and Request for Reimbursement for Construction Programs. Federal agencies may, however, prescribe the Request for Advance or Reimbursement form, specified in §\_\_\_\_.41(d), instead of this form.

(ii) The frequency for submitting reimbursement requests is treated in §\_\_\_\_.41(b)(3).

(2) Grants that support construction activities paid by letter of credit, electronic funds transfer or Treasury check advance.

(i) When a construction grant is paid by letter of credit, electronic funds transfer or Treasury check advances, the grantee will report its outlays to the Federal agency using Standard Form 271, Outlay Report and Request for Reimbursement for Construction Programs. The Federal agency will provide any necessary special instruction. However, frequency and due date shall be governed by §\_\_\_\_.41(b)(3) and (4).

(ii) When a construction grant is paid by Treasury check advances based on periodic requests from the grantee, the advances will be requested on the form specified in §\_\_\_\_.41(d).

(iii) The Federal agency may substitute the Financial Status Report specified in §\_\_\_\_.41(b) for the Outlay Report and Request for Reimbursement for Construction Programs.

(3) *Accounting basis.* The accounting basis for the Outlay Report and Request for Reimbursement for Construction Programs shall be governed by §\_\_\_\_.41(b)(2).

**§ \_\_\_\_ .42 Retention and access requirements for records.**

(a) *Applicability.* (1) This section applies to all financial and programmatic records, supporting documents, statistical records, and other records of grantees or subgrantees which are:

(i) Required to be maintained by the terms of this Part, program regulations or the grant agreement, or

(ii) *Otherwise reasonably considered as pertinent to program regulations or the grant agreement.*

(2) This section does not apply to records maintained by contractors or subcontractors. For a requirement to place a provision concerning records in certain kinds of contracts, see § \_\_\_\_ .36(i)(10) .

(b) *Length of retention period.* (1) Except as otherwise provided, records must be retained for three years from the starting date specified in paragraph (c) of this section.

(2) If any litigation, claim, negotiation, audit or other action involving the records has been started before the expiration of the 3-year period, the records must be retained until completion of the action and resolution of all issues which arise from it, or until the end of the regular 3-year period, whichever is later.

(3) To avoid duplicate recordkeeping, awarding agencies may make special arrangements with grantees and subgrantees to retain any records which are continuously needed for joint use. The awarding agency will request transfer of records to its custody when it determines that the records possess long-term retention value. When the records are transferred to or maintained by the Federal agency, the 3-year retention requirement is not applicable to the grantee or subgrantee.

(c) *Starting date of retention period—*(1) *General.* When grant support is continued or renewed at annual or other intervals, the retention period for the records of each funding period starts on the day the grantee or subgrantee submits to the awarding agency its single or last expenditure report for that period. However, if grant support is continued or renewed quarterly, the retention period for each year's records starts on the day the grantee submits its expenditure report for the last quarter of the Federal fiscal year. In all other cases, the retention period starts on the day the grantee submits its final expenditure report. If an expenditure report has been waived, the retention period starts on the day the report would have been due.

(2) *Real property and equipment records.* The retention period for real property and equipment records starts from the date of the disposition or replacement or transfer at the direction of the awarding agency.

(3) *Records for income transactions after grant or subgrant support.* In some cases grantees must report income after the period of grant support. Where there is such a requirement, the retention period for the records pertaining to the earning of the income starts from the end of the grantee's fiscal year in which the income is earned.

(4) *Indirect cost rate proposals, cost allocations plans, etc.* This paragraph applies to the following types of documents, and their supporting records: indirect cost rate computations or proposals, cost allocation plans, and any similar accounting computations of the rate at which a particular group of costs is chargeable (such as computer usage chargeback rates or composite fringe benefit rates).



(i) *If submitted for negotiation.* If the proposal, plan, or other computation is required to be submitted to the Federal Government (or to the grantee) to form the basis for negotiation of the rate, then the 3-year retention period for its supporting records starts from the date of such submission.

(ii) *If not submitted for negotiation.* If the proposal, plan, or other computation is not required to be submitted to the Federal Government (or to the grantee) for negotiation purposes, then the 3-year retention period for the proposal plan, or computation and its supporting records starts from end of the fiscal year (or other accounting period) covered by the proposal, plan, or other computation.

(d) *Substitution of microfilm.* Copies made by microfilming, photocopying, or similar methods may be substituted for the original records.

(e) *Access to records*—(1) *Records of grantees and subgrantees.* The awarding agency and the Comptroller General of the United States, or any of their authorized representatives, shall have the right of access to any pertinent books, documents, papers, or other records of grantees and subgrantees which are pertinent to the grant, in order to make audits, examinations, excerpts, and transcripts.

(2) *Expiration of right of access.* The rights of access in this section must not be limited to the required retention period but shall last as long as the records are retained.

(f) *Restrictions on public access.* The Federal Freedom of Information Act (5 U.S.C. 552) does not apply to records. Unless required by Federal, State, or local law, grantees and subgrantees are not required to permit public access to their records.

#### § 43 Enforcement.

(a) *Remedies for noncompliance.* If a grantee or subgrantee materially fails to comply with any term of an award, whether stated in a Federal statute or regulation, an assurance, in a State plan or application, a notice of award, or elsewhere, the awarding agency may take one or more of the following actions, as appropriate in the circumstances:

(1) Temporarily withhold cash payments pending correction of the deficiency by the grantee or subgrantee or more severe enforcement action by the awarding agency.

(2) Disallow (that is, deny both use of funds and matching credit for) all or part of the cost of the activity or action not in compliance.

(3) Wholly or partly suspend or terminate the current award for the grantee's or subgrantee's program.

(4) Withhold further awards for the program, or

(5) Take other remedies that may be legally available.

(b) *Hearings, appeals.* In taking an enforcement action, the awarding agency will provide the grantee or subgrantee an opportunity for such hearing, appeal, or other administrative proceeding to which the grantee or subgrantee is entitled under any statute or regulation applicable to the action involved.

(c) *Effects of suspension and termination.* Costs of grantee or subgrantee resulting from obligations incurred by the grantee or subgrantee during a suspension or after termination of an award are not allowable unless the awarding agency expressly authorizes them in the notice of suspension or termination or subsequently. Other grantee or subgrantee costs during suspension or after termination which are necessary and not reasonably avoidable are allowable if:

(1) The costs result from obligations which were properly incurred by the grantee or subgrantee before the effective date of suspension or termination, are not in anticipation of it, and, in the case of a termination, are noncancelable, and,

(2) The costs would be allowable if the award were not suspended or expired normally at the end of the funding period in which the termination takes effect.

(d) *Relationship to Debarment and Suspension.* The enforcement remedies identified in this section, including suspension and termination, do not preclude grantee or subgrantee from being subject to "Debarment and Suspension" under E.O. 12549 (see §\_\_\_\_.35).

§\_\_\_\_.44 **Termination for convenience.** Except as provided in §\_\_\_\_.43 awards may be terminated in whole or in part only as follows:

(a) By the awarding agency with the consent of the grantee or subgrantee in which case the two parties shall agree upon the termination conditions, including the effective date and in the case of partial termination, the portion to be terminated, or

(b) By the grantee or subgrantee upon written notification to the awarding agency, setting forth the reasons for such termination, the effective date, and in the case of partial termination, the portion to be terminated. However, if, in the case of a partial termination, the awarding agency determines that the remaining portion of the award will not accomplish the purposes for which the award was made, the awarding agency may terminate the award in its entirety under either §\_\_\_\_.43 or paragraph (a) of this section.

#### **Subpart D—After-The-Grant Requirements**

##### **§\_\_\_\_.50 Closeout.**

(a) *General.* The Federal agency will close out the award when it determines that all applicable administrative actions and all required work of the grant has been completed.

(b) *Reports.* Within 90 days after the expiration or termination of the grant, the grantee must submit all financial, performance, and other reports required as a condition of the grant. Upon request by the grantee, Federal agencies may extend this timeframe. These may include but are not limited to:

(1) *Final performance or progress report.*

(2) *Financial Status Report (SF 269) or Outlay Report and Request for Reimbursement for Construction Programs (SF-271) (as applicable.)*

(3) *Final request for payment (SF-270) (if applicable).*

(4) *Invention disclosure (if applicable).*

(5) *Federally-owned property report:* In accordance with §\_\_\_\_.32(f), a grantee must submit an inventory of all federally owned property (as distinct from property acquired with grant funds) for which it is accountable and request disposition instructions from the Federal agency of property no longer needed.

(c) *Cost adjustment.* The Federal agency will, within 90 days after receipt of reports in paragraph (b) of this section, make upward or downward adjustments to the allowable costs.

(d) *Cash adjustments.* (1) The Federal agency will make prompt payment to the grantee for allowable reimbursable costs.

(2) The grantee must immediately refund to the Federal agency any balance of unobligated (unencumbered) cash advanced that is not authorized to be retained for use on other grants.

**§ \_\_\_\_ .51 Later disallowances and adjustments.**

The closeout of a grant does not affect:

(a) The Federal agency's right to disallow costs and recover funds on the basis of a later audit or other review;

(b) The grantee's obligation to return any funds due as a result of later refunds, corrections, or other transactions;

(c) Records retention as required in § \_\_\_\_ .42 ;

(d) Property management requirements in §§ \_\_\_\_ .31 and \_\_\_\_ .32 ; and

(e) Audit requirements in § \_\_\_\_ .26.

**§ \_\_\_\_ .52 Collection of amounts due.**

(a) Any funds paid to a grantee in excess of the amount to which the grantee is finally determined to be entitled under the terms of the award constitute a debt to the Federal Government. If not paid within a reasonable period after demand, the Federal agency may reduce the debt by:

(1) Making an administrative offset against other requests for reimbursements,

(2) Withholding advance payments otherwise due to the grantee, or

(3) Other action permitted by law.

(b) Except where otherwise provided by statutes or regulations, the Federal agency will charge interest on an overdue debt in accordance with the Federal Claims Collection Standards (4 CFR Ch. II). The date from which interest is computed is not extended by litigation or the filing of any form of appeal.

**Subpart E—Entitlement [Reserved]**

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### Federal Agency Implementation of the Common Rule

Listed below are the federal agencies that implemented the common rule applicable to grants to state and local governments and the *Code of Federal Regulations* citations to the agencies' regulations implementing the rule.

Department of Agriculture	7 CFR Part 3016
Department of Defense	32 CFR Part 278
Department of Education	34 CFR Part 80
Department of Energy	10 CFR Part 600
Department of Commerce	15 CFR Part 24
Department of Health and Human Services	45 CFR Part 92
Department of Housing and Urban Development	24 CFR Part 85
Department of the Interior	43 CFR Part 12
Department of Justice	28 CFR Part 66
Department of Labor	29 CFR 97
Department of State	22 CFR Part 135
Department of Transportation	49 CFR Part 18
Department of Veterans Affairs	38 CFR Part 43
ACTION	45 CFR Part 1234
Environmental Protection Agency	40 CFR Part 31
Federal Emergency Management Agency	44 CFR Part 13
Federal Mediation and Conciliation Service	29 CFR Part 1470
National Archives and Records Administration	36 CFR Part 1207
National Endowment for the Arts	45 CFR Part 1157
National Endowment for the Humanities	45 CFR Part 1174
Institute of Museum Services	45 CFR Part 1183
National Science Foundation	45 CFR Part 602
Small Business Administration	13 CFR Part 143

## Appendix G

### ***Key Events in the History of Auditing Federal Programs***

**G.1** From the 1960s to the present, federal assistance to state and local governments grew from a few billion dollars to an annualized level of over \$100 billion, and the debt securities sold by some 40,000 governmental entities to the public are now valued at market rates in the hundreds of billions of dollars.

**G.2** Since the 1960s, there has been an evolution in the nature of audits of federally assisted programs and the type of auditors performing such audits. The principal events have been highlighted by the issuance of more guidance relating to audits of federal programs, and this guidance has been increasingly specific and increasingly detailed.

**G.3** Throughout the 1960s, the federal government supported a concept of grant-by-grant audits. By the mid-1970s, more than 100 individual program audit guides had been issued. As a partial response to the myriad of program audit guides, the U.S. General Accounting Office (GAO) attempted to bring uniformity to audits of government programs, activities, and functions through the issuance of *Government Auditing Standards*, often referred to as the Yellow Book. These standards were issued by the GAO in 1972 and revised in 1974, 1981, 1988, and 1994. The four earlier versions are superseded, and should not be used.

**G.4** In 1972, the U.S. Office of Management and Budget (OMB) issued government-wide administrative regulations governing the administration of grants and contracts with state and local governments. This guidance was contained in OMB Circular A-102, *Uniform Requirements for Grants and Cooperative Agreements with State and Local Governments*.

**G.5** In 1979, the OMB issued Attachment P, "Audit Requirements," to OMB Circular A-102, requiring that a single audit be made of federal assistance programs managed or administered by individual government units and that the single audit report be accepted by all federal agencies. The Single Audit Act of 1984 (P.L. 98-502, 31 U.S.C. 7501-7807), passed by Congress in 1984, codified many of the audit requirements established administratively under Attachment P. The Single Audit Act is included in its entirety in appendix C.

**G.6** After passage of the Single Audit Act, significant guidance relating to audits of federal programs has included the following:

- In April 1985, the OMB issued Circular A-128, *Audits of State and Local Governments*, to implement the Single Audit Act. OMB Circular A-128 superseded Attachment P to OMB Circular A-102. Circular A-128 is included in its entirety in appendix E.
- In 1985, and again in 1990, the OMB, in cooperation with many federal agencies, revised the *Compliance Supplement for Single Audits of State and Local Governments* (A-128 Compliance Supplement), which was most recently revised in September 1990. The A-128 Compliance Supplement contains the legal and regulatory requirements, along with suggested audit procedures, for the most significant federal assistance programs, which constitute about 95 percent of the total

federal financial assistance provided to state and local governments. The earlier 1980 and 1985 versions have now been superseded and should not be used.

- In 1986, the AICPA revised the Audit and Accounting Guide *Audits of State and Local Governmental Units* to address the specialized reporting principles and auditing practices related to the audit of federal financial assistance programs under the Single Audit Act and Circular A-128. The audit guide was later amended by AICPA Statement of Position (SOP) 89-6, *Auditors' Reports in Audits of State and Local Governmental Units*, and SOP 90-9, *The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act*, and SOP 92-7, *Audits of State and Local Governments Receiving Federal Financial Assistance*.
- In 1987, the AICPA published the *Report of the Task Force on the Quality of Audits of Governmental Units*. The primary objective of the task force was to develop a comprehensive plan of action designed to improve the quality of audits of governmental units. The task force identified twenty-five specific recommendations for improving the quality of audits. These recommendations have been categorized into five areas commonly referred to as the "five Es": education, engagement, evaluation, enforcement, and exchange. In 1989, the task force issued a final report noting the successful implementation of all but one of the twenty-five recommendations.
- In March 1988, the OMB issued two documents revising Circular A-102, one of which was *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*, referred to as the Common Rule. The Common Rule includes guidance for state and local government recipients of federal assistance, and is included in appendix F.
- In April 1989, the AICPA issued Statement on Auditing Standards (SAS) No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*. SAS No. 63 described the auditor's responsibility for testing and reporting on compliance with laws, regulations, and contractual terms governing financial assistance received from the federal government. In December 1991, SAS No. 63 was superseded by SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*. In February 1995, SAS No. 68 was superseded by SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801).
- In March 1990, the OMB issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. Circular A-133 supersedes paragraph 2h of Attachment F to OMB Circular A-110 and represents the audit requirements for colleges and universities and nonprofit organizations receiving federal financial assistance. However, certain colleges and universities may continue to have audits conducted in accordance with OMB Circular A-128.
- In 1993, the AICPA issued SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, to provide guidance on conducting audits in accordance with OMB Circular A-133.

- In August 1994, the AICPA revised the Audit and Accounting Guide *Audits of State and Local Governmental Units*. This revision superseded the 1986 guide and all prior SOPs.
- In April 1996, the OMB revised OMB Circular A-133. Among the most significant changes, the revised Circular raises the dollar threshold for single audit coverage to \$300,000, implements a risk-based approach to selecting major programs, revises the definition of non-profit organizations to include non-profit hospitals, and requires auditors to include a summary of audit results in the Schedule of Findings and Questioned Costs. The revised Circular is effective for audits of fiscal years beginning after June 30, 1996, with early application prohibited.
- In July 1996, legislation was passed amending the Single Audit Act of 1984. The new law (Public Law 104-156) made several important changes to the Act including, among other provisions, the extension of the Act's jurisdiction to not-for-profit organizations, an increase in the audit threshold to \$300,000, and the implementation of a risk-based audit approach. The Single Audit Act Amendments of 1996 are effective for fiscal years beginning after June 30, 1996, with early application prohibited.

**G.7** Today there are more than 15,000 governmental entities required to have audits under the Single Audit Act and Circular A-128. The majority of these audits are done by independent certified public accountants.

**G.8** The OMB estimates that 50,000 or more nonprofit entities are subject to its Circular A-133. The higher threshold for single audit coverage discussed in the last two bullets of G.6 will likely reduce the number of entities subject to the Single Audit Act and OMB Circular A-133.

## Appendix H

### *Single Audit Literature*

**H.1** Single audits are conducted in accordance with generally accepted auditing standards (GAAS), *Government Auditing Standards*, often referred to as the Yellow Book, the Single Audit Act of 1984, and Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments*.

**H.2** In planning, conducting, and reporting in connection with a single audit, independent auditors should consider becoming familiar with the pertinent documents listed below, many of which are discussed in Part VII, "Audits of Federal Financial Assistance," of this guide.

### Federal Statute

- The Single Audit Act of 1984, Public Law 98-502, is included herein as appendix C.

### Office of Management and Budget

#### Requirements and Guidelines

- Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments*, issued in April 1985, is included herein in appendix E.
- OMB *Compliance Supplement for Single Audits of State and Local Governments* was revised in September 1990. Earlier 1980 and 1985 editions have been superseded and should not be used.
- OMB *Questions and Answers on the Single Audit Provisions of OMB Circular A-128*, included herein as appendix D, addresses a number of the implementation issues of OMB Circular A-128.
- *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments—Final Rule (Common Rule)* (*Federal Register*, vol. 53, no. 48, March 11, 1988) was effective October 6, 1988, and is included herein as appendix F.
- OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*, was revised in April 1996. The revised Circular is effective for audits of fiscal years beginning after June 30, 1996, with early application prohibited.
- OMB *Compliance Supplement for Single Audits of Institutions of Higher Education and Nonprofit Institutions* was issued in October 1991.
- OMB *Questions and Answers on OMB Circular A-133 (Audits of Institutions of Higher Education and Other Nonprofit Institutions)* addresses a number of the implementation issues of OMB Circular A-133, which was issued as PCIE Position Statement No. 6.

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\* As of the date of this guide's issuance.



### Cost Principles

- OMB Circular A-87, *Cost Principles Applicable to Grants and Contracts*, revised in May 1995. (Appendix E of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* contains a synopsis.)
- OMB Circular A-21, *Cost Principles for Educational Institutions*, revised in May 1996.

### AICPA Auditing Standards and Guidance

- Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, Professional Standards, vol. 1, AU sec. 801)
- AICPA May 1991 Financial Report Summary, *Illustrations of Compliance Findings in Single Audit Reports of Local Governmental Units* (New York: AICPA, 1991)

### U.S. General Accounting Office

- *Government Auditing Standards* (1994 revision) was issued by the Comptroller General of the United States and is frequently referred to as the Yellow Book. Earlier 1972, 1974, 1981, and 1988 editions have been superseded and should not be used.
- *Assessing Compliance with Applicable Laws and Regulations* was issued in December 1989 by the General Accounting Office (GAO) Office of Policy.

### President's Council on Integrity and Efficiency

- *Federal Cognizant Agency Audit Organization Guidelines* was revised in November 1987 and is frequently referred to as the Orange Book.
- The President's Council on Integrity and Efficiency (PCIE) Position Statements address implementation issues of the single audit and serve essentially as supplemental guidance to federal officials beyond the Orange Book:
  - *Statement No. 1*, issued February 4, 1987, involves guidance when a series of audits of individual departments, agencies, and establishments may be considered an audit for single audit purposes.
  - *Statement No. 2*, issued February 4, 1987, endorses the 50 percent rule on internal control coverage prescribed by the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*.
  - *Statement No. 3*, issued July 19, 1988, involves guidance on frequency of required internal control reviews of nonmajor programs.
  - *Statement No. 4*, issued December 5, 1988, establishes uniform procedures for referral of substandard audits to state boards of accountancy and the AICPA.
  - *Statement No. 5*, issued September 8, 1989, establishes audit guidance for "other non-profit" entities not covered by OMB Circular A-110. *Statement No. 6* contains "questions and answers" for implementing OMB Circular A-133.
- PCIE's *Uniform Desk Review and Quality Control Review Guides for Single Audits*, December 1991 is used by the personnel of the Federal

Inspector General to review the quality of audit reports and an auditor's workpapers when a single audit is reviewed by Inspector General personnel. These guides are available on request from Regional Inspectors General for Audit.

### **General Services Administration**

- *OMB Catalog of Federal Domestic Assistance* is compiled and published annually by the General Services Administration and available from the Superintendent of Documents, U.S. Government Printing Office.

## Appendix I

### ***Federal Quality Control Procedures***

I.1 Not all single audit reports received by the cognizant agency are subjected to all the quality control procedures included in *Federal Cognizant Agency Audit Organization Guidelines* (the Orange Book). Reports that are examined are usually selected on a statistical or random basis established by each cognizant agency. The sequential phases through which audit reports may be subjected for review include a desk review, a workpaper review, an on-site review, and a quality assessment review of the audit organization.

### **Desk Reviews**

I.2 Almost all single audit reports receive a desk review by the cognizant agency. The principal purpose of a desk review is to determine whether all the individual reports and the corrective plan of action required by the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments*, have been submitted by the recipient to the cognizant agency. The cognizant agencies, through the President's Council on Integrity and Efficiency (PCIE), have developed a uniform desk review checklist that sets forth the following principal subjects to be addressed:

- a. *Auditor's qualifications*—Do the single audit reports contain any indication that the auditor does not meet the qualifications and independence standards contained in *Government Auditing Standards*?
- b. *Financial statements*—Do the single audit reports contain all required financial statements, including notes thereto, and the Supplementary Schedule of Federal Financial Assistance (Supplementary Schedule), and do they indicate whether the financial statements and the Supplementary Schedule cover the entire operations of the government? Do they also indicate whether the auditor's report on the financial statements states that the audit has been done in accordance with *Government Auditing Standards* and whether the report contains an opinion on whether the financial statements are presented fairly in accordance with GAAP or some other basis of accounting? Furthermore, do the single audit reports indicate whether the auditor's report is included on the Supplementary Schedule?
- c. *Internal control structure*—Do the single audit reports include the auditor's reports on the government's internal control structure observed during the audit of the financial statements and on the government's management of federal financial assistance programs, and do these reports contain the identification of the significant controls designed to provide reasonable assurance that federal programs are being managed in compliance with applicable laws and regulations, including reportable conditions and material weaknesses?
- d. *Compliance*—Do single audit reports include the necessary auditor's reports, as applicable? An opinion on the specific compliance require-

ments related to major programs, a report giving positive and negative assurance on the general compliance requirements, and a report giving positive and negative assurance on the specific compliance items tested for nonmajor federal financial assistance programs are required. If there are no major federal financial assistance programs, reports giving positive and negative assurance on the general compliance requirements for the specific compliance items tested for nonmajor federal financial assistance programs are required.

- e. *Other matters*—Does the information on the identification of amounts, questions, noncompliance, and the findings and recommendations provided by the auditor present sufficient detail to facilitate resolution by federal program officials, and does the government provide comments and a corrective action plan addressing the auditor's findings and recommendations?

## Workpaper Reviews

**I.3** Although the desk review may be an effective method for the cognizant agency to determine whether the single audit report meets the reporting requirements of the Single Audit Act and OMB Circular A-128, it does not provide an assessment of the quality of the work performed by the auditor. Each cognizant agency has established procedures for selecting a representative number of single audits on which to perform an on-site review of the auditor's workpapers.

**I.4** The workpaper review covers all aspects of the audit work, with particular emphasis on the audit of federal funds. As with desk reviews, the cognizant agencies, through the PCIE, have developed a uniform checklist that sets forth the following principal subjects to be addressed:

- a. *Audit engagement*—Was an audit engagement letter or other agreement executed?
- b. *Auditor independence*—Are the workpapers free of any indication that the auditor lacks independence because of personal or external impairment?
- c. *Auditor's qualifications*—Is the auditor a licensed CPA (or a public accountant licensed on or before December 31, 1970)?
- d. *Planning and supervision*—Is there evidence that the auditor possessed or performed procedures to acquire sufficient knowledge to understand the government's internal control structure as it affects the financial statements and the management of federal financial assistance programs?
- e. *Fieldwork*—Do the audit procedures employed and the tests performed in obtaining evidential matter comply with *Government Auditing Standards*?
- f. *Continuing Professional Education (CPE)*—Have the auditors complied with the appropriate CPE requirements?
- g. *Quality reviews*—Does the audit organization have an internal quality control review process established and does it participate in an external quality review program?
- h. *Books and records*—Are there sufficient data to demonstrate that the financial statements, the Supplementary Schedule, and other data

on which the auditor is reporting are either in agreement, or have been reconciled, with the government's records?

- i. *Findings and recommendations*—Do the reports issued by the auditor include all major internal control weaknesses and all instances of noncompliance identified in the workpapers? Furthermore, has the auditor ensured that all potential illegal acts were reported to the appropriate officials?

## On-Site Reviews at the Government Auditee's Location

**I.5** In selected instances, the cognizant agency may elect to perform an on-site review to compare the auditor's workpapers with the government's books and records to ensure that the workpapers accurately portray the conditions cited.

## Reviews of Audit Organization

**I.6** In determining the depth of coverage to be examined during an on-site review, the cognizant agency may review and consider the results of any quality reviews performed under any of the programs recognized as acceptable in *Government Auditing Standards*.

## Resolving Deficiencies Noted

**I.7** When the cognizant agency identifies any deficiencies noted during its desk, workpaper, or on-site reviews, it will notify the auditor and government in writing, setting forth the—

- a. Reason why the work is inadequate
- b. Impact of the noted inadequacies
- c. Recommendations for resolving the inadequacies
- d. Time frame for accomplishing corrective action
- e. Possible sanctions

**I.8** If corrective action does not occur, the cognizant agency may initiate a series of sanctions, including—

- Recommending that the audited government impose any sanctions provided for in its contract for audit services.
- Recommending that the federal agencies impose any of the sanctions set forth in OMB Circular A-128, which include withholding a part or all of any federal assistance payments due the government, withholding or disallowing overhead payments, or suspending the federal grant agreement until an acceptable single audit is completed.
- Invoking the provision in the Single Audit Act that no audit cost may be charged to federal assistance programs for audits not made in accordance with OMB Circular A-128 requirements.
- Referring substandard work to appropriate professional and regulatory bodies, if warranted. In PCIE Position Statement No. 4, the cognizant agencies have developed a uniform package they use for referring substandard work.

## Appendix J

### ***Acronyms and Abbreviations***

*AICPA*—American Institute of Certified Public Accountants  
*ASBO*—Association of School Business Officials  
*CAFR*—Comprehensive Annual Financial Report  
*EEOC*—Equal Employment Opportunity Commission  
*ERISA*—Employee Retirement Income Security Act  
*FAF*—Financial Accounting Foundation  
*FASB*—Financial Accounting Standards Board  
*GAAFR*—Governmental Accounting, Auditing, and Financial Reporting—  
     GFOA  
*GAAP*—Generally Accepted Accounting Principles  
*GAAS*—Generally Accepted Auditing Standards  
*GAGAS*—Generally Accepted Government Auditing Standards  
*GAO*—General Accounting Office, United States  
*GASAC*—Governmental Accounting Standards Advisory Council  
*GASB*—Governmental Accounting Standards Board  
*GFAAG*—General Fixed Assets Account Group  
*GFOA*—Government Finance Officers Association of the United States and  
     Canada  
*GLTDAG*—General Long-Term Debt Account Group  
*GPFS*—General-Purpose Financial Statements  
*HUD*—Housing and Urban Development, U.S. Department of  
*IBNR*—Incurred But Not Reported (Claims)  
*NACUBO*—National Association of College and University Business Officials  
*NCGA*—National Council on Governmental Accounting  
*OMB*—Office of Management and Budget, United States  
*PERS*—Public Employees Retirement System  
*SAS*—Statement on Auditing Standards  
*SOP*—Statement of Position by Committees of the AICPA  
*USDA*—U.S. Department of Agriculture  
*YELLOW BOOK*—*Government Auditing Standards* issued by Comptroller  
     General of the U.S., 1988

## Appendix K

### ***Interpretation of SAS No. 41, Working Papers, Titled, “Providing Access to or Photocopies of Working Papers to a Regulator”<sup>1,2</sup>***

**.01 Question**—Paragraph 6 of SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339.06), states that “working papers are the property of the auditor and some states have statutes that designate the auditor as the owner of the working papers. The auditor’s rights of ownership, however, are subject to ethical limitations relating to the confidential relationship with clients.” In addition, paragraph 8 of SAS No. 41 (AICPA, *Professional Standards*, vol. 1, AU sec. 339.08) states that, “The auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period sufficient to meet the needs of his practice and to satisfy any pertinent legal requirements of records retention.”

Notwithstanding the provisions of paragraphs 6 and 8 of SAS No. 41, auditors are sometimes required by law, regulation or audit contract,<sup>3</sup> to provide a regulator, or a duly appointed representative, access to working papers. For example, a regulator may request access to the working papers to fulfill a quality review requirement or to assist in establishing the scope of a regulatory examination. Furthermore, as part of the regulator’s review of the working papers, the regulator may request photocopies of all or selected portions of the working papers during or after the review. The regulator may intend, or decide, to make photocopies (or information derived from the original working papers) available to others, including other governmental agencies, for their particular purposes, with or without the knowledge of the auditor or the client. When a regulator requests the auditor to provide access to (and possibly photocopies of) working papers pursuant to law, regulation or audit contract, what steps should the auditor take?

**.02 Interpretation**—When a regulator requests access to working papers pursuant to law, regulation or audit contract, the auditor should take the following steps:

- a.** Consider advising the client that the regulator has requested access to (and possibly photocopies of) the working papers and that the aud-

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<sup>1</sup> The term “regulator(s)” includes federal, state and local government officials with legal oversight authority over the entity. Examples of regulators who may request access to working papers include, but are not limited to, state insurance and utility regulators, various health care authorities, and federal agencies such as the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Department of Housing and Urban Development, the Department of Labor, and the Rural Electrification Administration.

<sup>2</sup> The guidance in this Interpretation does not apply to requests from the Internal Revenue Service, firm practice-monitoring programs to comply with AICPA or state professional requirements such as peer or quality reviews, proceedings relating to alleged ethics violations, or subpoenas.

<sup>3</sup> For situations in which the auditor is not required by law, regulation or audit contract to provide a regulator access to the working papers, reference should be made to the guidance in paragraphs .11-.15 of this Interpretation.

itor intends to comply with such request.<sup>4</sup>

- b. Make appropriate arrangements with the regulator for the review.
- c. Maintain control over the original working papers, and
- d. Consider submitting the letter described in paragraph .05 of this Interpretation to the regulator.

**.03** The auditor should make appropriate arrangements with the regulator. These arrangements ordinarily would include the specific details such as the date, time and location of the review. The working papers may be made available to a regulator at the offices of the client, the auditor, or a mutually agreed-upon location, so long as the auditor maintains control. Furthermore, the auditor should take appropriate steps to maintain custody of the original working papers. For example, the auditor (or his or her representative) should consider being present when the original working papers are reviewed by the regulator. Maintaining control of the working papers is necessary to ensure the continued integrity of the working papers and to ensure confidentiality of client information.

**.04** Ordinarily, the auditor should not agree to transfer ownership of the working papers to a regulator. Furthermore, the auditor should not agree, without client authorization, that the information contained therein about the client may be communicated to or made available to any other party. In this regard, the action of an auditor providing access to, or photocopies of, the working papers shall not constitute transfer of ownership or authorization to make them available to any other party.

**.05** An audit performed in accordance with generally accepted auditing standards is not intended to, and does not, satisfy a regulator's oversight responsibilities. To avoid any misunderstanding, prior to allowing a regulator access to the working papers, the auditor should consider submitting a letter to the regulator that:

- a. Sets forth the auditor's understanding of the purpose for which access is being requested
- b. Describes the audit process and the limitations inherent in a financial statement audit
- c. Explains the purpose for which the working papers were prepared, and that any individual conclusions must be read in the context of the auditor's report on the financial statements
- d. States, except when not applicable, that the audit was not planned or conducted in contemplation of the purpose for which access is being granted or to assess the entity's compliance with laws and regulations

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<sup>4</sup> The auditor may wish (and in some cases may be required by law, regulation, or audit contract) to confirm in writing with the client that the auditor may be required to provide a regulator access to the working papers. Sample language that may be used follows:

"The working papers for this engagement are the property of (*name of auditor*) and constitute confidential information. However, we may be requested to make certain working papers available to (*name of regulator*) pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of (*name of auditor*) personnel. Furthermore, upon request, we may provide photocopies of selected working papers to (*name of regulator*). The (*name of regulator*) may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies."



- e. States that the audit and the working papers should not supplant other inquiries and procedures that should be undertaken by the regulator for its purposes
- f. Requests confidential treatment under the Freedom of Information Act or similar laws and regulations,<sup>5</sup> when a request for the working papers is made, and that written notice be given to the auditor before transmitting any information contained in the working papers to others, including other governmental agencies, except when such transfer is required by law or regulation, and
- g. States that if any photocopies are to be provided, they will be identified as "Confidential Treatment Requested by (*name of auditor, address, telephone number*)."

The auditor may wish to obtain a signed acknowledgment copy of the letter as evidence of the regulator's receipt of the letter.

**.06** An example of a letter containing the elements described in paragraph .05 of this Interpretation is presented below:

### Illustrative Letter to Regulator<sup>6</sup>

(*Date*)

(*Name and Address of Regulatory Agency*)

Your representatives have requested access to our working papers in connection with our audit of the December 31, 19XX financial statements of (*name of client*). It is our understanding that the purpose of your request is (*state purpose: for example, "to facilitate your regulatory examination"*).<sup>7</sup>

Our audit of (*name of client*) December 31, 19XX financial statements was conducted in accordance with generally accepted auditing standards,<sup>8</sup> the objective<sup>9</sup> of which is to form an opinion as to whether the financial statements, which are the responsibility and representations of management, present fairly, in all material respects, the financial position, results of operations and cash flows in conformity with generally accepted accounting principles.<sup>10</sup> Under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to design our audit

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<sup>5</sup> The auditor may need to consult the regulations of individual agencies and, if necessary, consult with legal counsel regarding the specific procedures and requirements necessary to gain confidential treatment.

<sup>6</sup> The auditor should appropriately modify this letter when the audit has been performed in accordance with generally accepted auditing standards and also in accordance with additional auditing requirements specified by a regulatory agency (for example, the requirements specified in *Government Auditing Standards* issued by the Comptroller General of the United States).

<sup>7</sup> If the auditor is not required by law, regulation, or audit contract to provide a regulator access to the working papers but otherwise intends to provide such access (see paragraphs .11-.15 of this Interpretation), the letter should include a statement that: "Management of (*name of client*) has authorized us to provide you access to our working papers for (*state purpose*)."

<sup>8</sup> Refer to footnote 6.

<sup>9</sup> In an audit performed in accordance with the *Single Audit Act of 1984*, and certain other federal audit requirements, an additional objective of the audit is to assess compliance with laws and regulations applicable to federal financial assistance. Accordingly, in these situations, the above letter should be modified to include the additional objective.

<sup>10</sup> If the financial statements have been prepared in conformity with regulatory accounting practices, the phrase "financial position, results of operations and cash flows in conformity with generally accepted accounting principles" should be replaced with appropriate wording such as, in the case of an insurance company, the "admitted assets, liabilities . . . of the XYZ Insurance Company in conformity with accounting practices prescribed or permitted by the state of . . . insurance department."

to provide reasonable assurance that errors and irregularities that have a material effect on the financial statements will be detected, and to exercise due care in the conduct of our audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and as to the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Thus, our audit, based on the concept of selective testing, is subject to the inherent risk that material errors or irregularities, if they exist, would not be detected. In addition, an audit does not address the possibility that material errors or irregularities may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may have existed that would have been assessed differently by you.

The working papers were prepared for the purpose of providing the principal support for our report on (*name of client*) December 31, 19XX financial statements and to aid in the conduct and supervision of our audit. The working papers document the procedures performed, the information obtained and the pertinent conclusions reached in the engagement. The audit procedures that we performed were limited to those we considered necessary under generally accepted auditing standards<sup>11</sup> to enable us to formulate and express an opinion on the financial statements<sup>12</sup> taken as a whole. Accordingly, we make no representation as to the sufficiency or appropriateness, for your purposes, of either the information contained in our working papers or our audit procedures. In addition, any notations, comments, and individual conclusions appearing on any of the working papers do not stand alone, and should not be read as an opinion on any individual amounts, accounts, balances or transactions.

Our audit of (*name of client*) December 31, 19XX financial statements was performed for the purpose stated above and has not been planned or conducted in contemplation of your (*state purpose: for example, "regulatory examination"*) or for the purpose of assessing (*name of client*) compliance with laws and regulations.<sup>13</sup> Therefore, items of possible interest to you may not have been specifically addressed. Accordingly, our audit and the working papers prepared in connection therewith, should not supplant other inquiries and procedures that should be undertaken by the (*name of regulatory agency*) for the purpose of monitoring and regulating the financial affairs of the (*name of client*). In addition, we have not audited any financial statements of (*name of client*) since (*date of audited balance sheet referred to in the first paragraph above*) nor have we performed any audit procedures since (*date*), the date of our auditor's report, and significant events or circumstances may have occurred since that date.

The working papers constitute and reflect work performed or information obtained by (*name of auditor*) in its capacity as independent auditor for (*name of client*). The documents contain trade secrets and confidential commercial and financial information of our firm and (*name of client*) that is privileged and confidential, and we expressly reserve all rights with respect to disclosures to third parties. Accordingly, we request confidential treatment under the Freedom of Information Act or similar laws and regulations<sup>14</sup> when requests are made for the working papers or information contained therein or any documents created by the (*name of regulatory agency*) containing information

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<sup>11</sup> Refer to footnote 6.

<sup>12</sup> Refer to footnote 9.

<sup>13</sup> Refer to footnote 9.

<sup>14</sup> Refer to footnote 5.

derived therefrom. We further request that written notice be given to our firm before distribution of the information in the working papers (or photocopies thereof) to others, including other governmental agencies, except when such distribution is required by law or regulation.

*[If it is expected that photocopies will be requested, add:*

Any photocopies of our working papers we agree to provide you will be identified as "Confidential Treatment Requested by (name of auditor, address, telephone number)."]

Firm signature

**.07 Question**—A regulator may request access to the working papers before the audit has been completed and the report released. May the auditor allow access in such circumstances?

**.08 Interpretation**—When the audit has not been completed, the working papers are necessarily incomplete because (a) additional information may be added as a result of further tests and review by supervisory personnel and (b) any audit results and conclusions reflected in the incomplete working papers may change. Accordingly, it is preferable that access be delayed until all audit procedures have been completed and all internal reviews have been performed. If access is provided prior to completion of the audit, the auditor should consider issuing the letter referred to in paragraph .05 of this Interpretation, appropriately modified, and including additional language along the following lines:

"We have been engaged to audit in accordance with generally accepted auditing standards the December 31, 19XX, financial statements of XYZ Company, but have not as yet completed our audit. Accordingly, at this time we do not express any opinion on the Company's financial statements. Furthermore, the contents of the working papers may change as a result of additional audit procedures and review of the working papers by supervisory personnel of our firm. Accordingly, our working papers are incomplete."

Because the working papers may change prior to completion of the audit, the auditor ordinarily should not provide photocopies of the working papers until the audit has been completed.

**.09 Question**—Some regulators may engage an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency. Are there any special precautions the auditor should observe in these circumstances?

**.10 Interpretation**—The auditor should be satisfied that the party engaged by the regulator is subject to the same confidentiality restrictions as the regulatory agency itself. This can be accomplished by obtaining acknowledgment, preferably in writing, from the regulator stating that the third party is acting on behalf of the regulator and agreement from the third party that he or she is subject to the same restrictions on disclosure and use of working papers and the information contained therein as the regulator.

**.11 Question**—When a regulator requests the auditor to provide access to (and possibly photocopies of) working papers and the auditor is not otherwise required by law, regulation or audit contract to provide such access, what steps should the auditor take?

**.12 Interpretation**—The auditor should obtain an understanding of the reasons for the regulator's request for access to the working papers and may wish to consider consulting with legal counsel regarding the request. If the auditor decides to provide such access, the auditor should obtain the client's consent, preferably in writing, to provide the regulator access to the working papers.

.13 Following is an example of language that may be used in the written communication to the client:

"The working papers for this engagement are the property of *(name of auditor)* and constitute confidential information. However, we have been requested to make certain working papers available to *(name of regulator)* for *(describe the regulator's basis for its request)*. Access to such working papers will be provided under the supervision of *(name of auditor)* personnel. Furthermore, upon request, we may provide photocopies of selected working papers to *(name of regulator)*).

"You have authorized *(name of auditor)* to allow *(name of regulator)* access to the working papers in the manner discussed above. Please confirm your agreement to the above by signing below and returning to *(name of auditor, address)*."

Firm signature

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Agreed and acknowledged:

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(Name and title)

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(Date)

.14 If the client requests to review the working papers before allowing the regulator access, the auditor may provide the client with the opportunity to obtain an understanding of the nature of the information about its financial statements contained in the working papers that are being made available to the regulator. When a client reviews the working papers, the auditor should maintain control of the working papers as discussed in paragraph .03 of this Interpretation.

.15 The auditor should also refer to the guidance in paragraphs .03-.10 of this Interpretation which provide guidance on making arrangements with the regulator for access to the working papers, maintaining control over the original working papers and submitting a letter describing various matters to the regulator.

[Issue Date: July, 1994.]

## Appendix L

### ***Schedule of Changes Made to Audits of State and Local Governmental Units***

<u>Reference</u>	<u>Change</u>	<u>Date</u>
Preface	Updated.	October, 1996
Paragraph 1.02	Revised to reflect the issuance of SAS No. 74.	August, 1995
Paragraph 1.03	Bureau of Census statistic updated; Bureau of Census reference updated in footnote 1.	August, 1995
Paragraph 1.04	Revised for clarity.	August, 1995
Paragraph 1.05	Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Not-for-Profit Organizations</i> .	October, 1996
Paragraph 1.06	Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Health Care Organizations</i> .	October, 1996
Paragraph 1.06 (footnote *)	Footnote deleted.	October, 1996
Paragraph 1.08	Added to reflect the issuance of GASB Statement No. 29; Subsequent paragraphs renumbered.	October, 1996
Renumbered paragraph 1.12	Revised to reflect the definition of government.	October, 1996
Renumbered paragraph 1.15	Revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Renumbered paragraph 1.20	Revised to reflect the issuance of SAS No. 74; Footnote 4 deleted.	August, 1995
Renumbered paragraphs 1.21, 1.22, and 1.23	Revised to conform to 1994 <i>Government Auditing Standards</i> ; Footnote 5 replaced.	August, 1995
Renumbered paragraph 1.26	Added parenthetical for clarity; Added reference to SOP 92-9.	August, 1995
Paragraph 3.01	Added a reference in the 8th bullet to the communications required by 1994 <i>Government Auditing Standards</i> ; 11th bullet revised for clarity.	August, 1995
Paragraph 3.04	Paragraph added; Subsequent paragraphs renumbered.	August, 1995
Renumbered paragraph 3.12	Revised for clarity.	August, 1995
Paragraph 3.21	Revised to reflect the issuance of SAS No. 77.	October, 1996

<u>Reference</u>	<u>Change</u>	<u>Date</u>
Renumbered paragraph 3.23 (7th bullet)	Added a bullet regarding the communications required by 1994 <i>Government Auditing Standards</i> .	August, 1995
Renumbered paragraph 3.26	Revised to reflect the issuance of SAS No. 74.	August, 1995
Renumbered paragraph 3.27	Revised for clarity.	August, 1995
Paragraph 3.28	Revised to reflect the issuance of SAS No. 77.	October, 1996
Renumbered paragraph 3.33	Added reference to new sections that follow this paragraph on working paper documentation and audit follow-up.	August, 1995
Paragraph 3.33	Revised to reflect the issuance of an Interpretation to SAS No. 19.	October, 1996
Paragraphs 3.34, 3.35, and 3.36	Added; Subsequent paragraphs further renumbered.	August, 1995
Paragraph 3.39	Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Health Care Organizations</i> .	October, 1996
Paragraph 3.41	Revised to reflect the issuance of GASB Statement No. 29 and the revised Audit and Accounting Guide <i>Not-for-Profit Organizations</i> .	October, 1996
Paragraphs 3.45 and 3.46	Revised to conform to a revision of Ethics Interpretation 101-10.	October, 1996
Paragraph 4.02 (footnote 7)	Revised to inform readers that SAS No. 78 has not been incorporated into this Guide.	October, 1996
Paragraph 4.09	Revised references to SAS No. 55 for clarity.	August, 1995
Paragraphs 4.12-4.20	Replaced with paragraphs 4.12 through 4.19 to conform to 1994 <i>Government Auditing Standards</i> ; Subsequent paragraphs renumbered.	August, 1995
Paragraphs 5.01, 5.02, 5.03, 5.04, and 5.05	Revised to reflect the issuance of SAS No. 74; 5.01 (b) revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Paragraph 5.08	Footnote 9 revised for clarity; Reference added to footnote 10.	August, 1995
Paragraph 5.20	Reference to footnote 7 added.	October, 1996
Paragraph 5.23	Revised for clarity.	August, 1995
Paragraph 5.24	Moved discussion of working paper requirements under <i>Government Auditing Standards</i> to paragraphs 3.34 and 3.35; Reference added to these paragraphs.	August, 1995

<u>Reference</u>	<u>Change</u>	<u>Date</u>
Paragraphs 5.26 and 5.27	Added; Subsequent paragraphs renumbered.	August, 1995
Renumbered paragraph 5.28	Moved discussion of audit follow-up to paragraph 3.36; Reference added to the discussion of additional internal control reporting responsibilities under <i>Government Auditing Standards</i> ; Footnote 14 deleted.	August, 1995
Former paragraphs 5.27-5.31	Replaced with paragraphs 5.29 through 5.34 to conform to 1994 <i>Government Auditing Standards</i> ; Subsequent paragraphs further renumbered.	August, 1995
Renumbered paragraph 5.35	Revised to conform to 1994 <i>Government Auditing Standards</i> ; Footnote 15 replaced.	August, 1995
Paragraph 5.35	Revised to correct an inaccuracy.	October, 1996
Paragraph 5.37	Revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Paragraphs 5.39 and 5.41	Revised to reflect the issuance of SAS No. 79.	October, 1996
Renumbered paragraphs 5.46 and 5.47	Revised to reflect the issuance of SSAE No. 3.	August, 1995
Paragraph 6.15	Revised to reflect the issuance of SAS No. 74.	August, 1995
Paragraph 6.26	Revised for clarity.	August, 1995
Paragraph 7.11	Revised to reflect the issuance of GASB Statement No. 28 and GASB Interpretation No. 3.	October, 1996
Paragraph 7.14	Added a bullet to reflect the issuance of GASB Technical Bulletin No. 94-1.	August, 1995
Paragraph 7.14	Revised to reflect the issuance of GASB Interpretation No. 3.	October, 1996
Paragraph 8.06	Revised to reflect the issuance of GASB Statement No. 24.	August, 1995
Paragraph 9.09	Revised to reflect the issuance of GASB Interpretation No. 4.	October, 1996
Paragraph 9.14	Added a reference to GASB Statement No. 17 for additional clarity.	August, 1995
Paragraph 9.14	Revised to reflect the issuance of GASB Statement No. 30.	October, 1996
Paragraph 11.13	Revised to reflect the issuance of GASB Interpretation No. 2.	October, 1996
Paragraph 11.31	Added a bullet to reflect the issuance of GASB Technical Bulletin No. 94-1.	August, 1995

<u>Reference</u>	<u>Change</u>	<u>Date</u>
Paragraph 11.32	Revised to reflect the issuance of GASB Interpretation No. 2.	October, 1995
Paragraph 13.11	Revised to reflect the issuance of GASB Interpretation No. 4.	October, 1996
Paragraph 13.25	Revised to reflect the issuance of GASB Statement No. 24.	August, 1995
Paragraph 13.30	Revised to reflect the issuance of GASB Statement No. 30.	October, 1996
Paragraph 13.32	Revised to reflect the issuance of GASB Interpretation No. 4.	October, 1996
Paragraph 13.33	Revised to reflect the issuance of GASB Statement No. 30.	October, 1996
Paragraph 13.37	Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Health Care Organizations</i> .	October, 1996
Paragraph 14.10	Revised to reflect the issuance of GASB Statement Nos. 25, 26, and 27.	August, 1995
Paragraph 14.14	Revised to reflect the issuance of GASB Statement No. 25.	August, 1995
Paragraph 14.25	Revised to reflect the issuance of SAS No. 73.	August, 1995
Paragraph 15.24	Revised to reflect the issuance of GASB Interpretation No. 2.	October, 1996
Paragraph 16.12	Revised to reflect the issuance of an Interpretation of SAS No. 19.	October, 1996
Paragraph 16.23	Revised to reflect the issuance of GASB Statement No. 24.	August, 1995
Paragraph 17.02	Deleted reference to SAS No. 68.	August, 1995
Paragraph 17.04	Revised to reflect the issuance of an Interpretation of SAS No. 19.	October, 1996
Paragraph 17.12	Revised to reflect the issuance of SAS No. 77.	October, 1996
Paragraph 17.17	Added a reference in the 10th bullet to paragraphs 9.13 and 9.14 for additional clarity.	August, 1995
Paragraphs 18.39 and 18.41	Revised for clarity.	August, 1995
Paragraphs 18.45 and 18.46	Added a reference to paragraph 3.12 for additional clarity.	August, 1995
Paragraph 18.48	Deleted as a result of the issuance of SAS No. 79; Subsequent paragraphs renumbered.	October, 1996
Paragraph 19.09	Revised to reflect the issuance of SAS Nos. 75 and 76, and SSAE No. 4.	October, 1996



<u>Reference</u>	<u>Change</u>	<u>Date</u>
Exhibit 20.1	Added a footnote to discuss the option under 1994 <i>Government Auditing Standards</i> that allows the reporting on internal controls and compliance in the report on the financial statements.	August, 1995
Paragraphs 20.08, 21.04(h), and 21.09	Revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Paragraph 21.21	Revised to reflect the issuance of SSAE No. 3.	August, 1995
Paragraph 21.25	3rd bullet revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Paragraph 21.29	Replaced reference to SAS No. 68 with OMB Circular A-128.	August, 1995
Paragraph 23.38	Deleted reference to SAS No. 68.	August, 1995
Paragraphs 23.67, 23.69, and 23.71	Revised to conform to a revision to OMB Circular A-87.	October, 1996
Paragraph 23.82	Revised to reflect the issuance of SAS No. 74.	August, 1995
Exhibit 24.1	Revised to conform to 1994 <i>Government Auditing Standards</i> ; Footnote added.	August, 1995
Paragraph 24.02	Revised to conform to 1994 <i>Government Auditing Standards</i> ; To reflect the issuance of SAS No. 74; For clarity.	August, 1995
Paragraphs 24.03 and 24.04	Revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Paragraph 24.19	Revised to reflect the issuance of SAS No. 79.	October, 1996
Paragraphs 24.20, 24.22, and 24.34	Revised for clarity.	August, 1995
Paragraphs 24.34, 24.37, 24.38, 24.39, 24.40, 24.41, and 24.42	Revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
<u>Appendix A:</u>		
Paragraph A.2	Revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Paragraph A.3	Revised for clarity.	August, 1995
Paragraph A.4	Paragraph added to discuss option of "combining" reports under <i>Government Auditing Standards</i> ; Subsequent paragraphs renumbered.	August, 1995
Renumbered paragraphs A.5 and A.6	Revised for clarity.	August, 1995

<u>Reference</u>	<u>Change</u>	<u>Date</u>
Example A.1	Revised and added footnotes to conform to 1994 <i>Government Auditing Standards</i> ; Subsequent footnotes renumbered.	August, 1995
Example A.2	Deleted former footnote 2; Subsequent footnotes further renumbered.	August, 1995
Examples A.2–A.10	Added footnotes to each report to conform to 1994 <i>Government Auditing Standards</i> ; Subsequent footnotes further renumbered.	August, 1995
Example A.10	Deleted as a result of the issuance of SAS No. 79.	October, 1996
Examples A.11–A.12(B)	Added footnotes to each report to conform to 1994 <i>Government Auditing Standards</i> ; Subsequent footnotes renumbered.	August, 1995
Example A.12(B)	Removed the words “general-purpose” from the first paragraph to correct an error.	August, 1995
Examples A.13–A.15	Added footnotes to each report to conform to 1994 <i>Government Auditing Standards</i> ; Subsequent footnotes further renumbered.	August, 1995
Examples A.17(A) and A.17(B)	Revised and added footnotes to conform to 1994 <i>Government Auditing Standards</i> ; Subsequent footnotes further renumbered.	August, 1995
Example A.17B	Revised as a result of the issuance of SAS No. 79.	October, 1996
Example A.18B	Deleted as a result of the issuance of SAS No. 79.	October, 1996
Example A.21	Revised as a result of the issuance of SAS No. 79.	October, 1996
Example A.23 (footnote 81)	Revised to correct an inaccuracy.	October, 1996
Examples A.25(A) and A.25(B)	Revised to conform to 1994 <i>Government Auditing Standards</i> .	August, 1995
Example A.25(B)	Deleted the word “specific” in the fifth paragraph to be consistent with other illustrative reports.	October, 1996
Appendix B (paragraph .010)	Revised to reflect the issuance of SAS No. 78.	October, 1996
Appendix E	Revised to conform to a revision to OMB Circular A-87.	October, 1996
Appendix G	Revised to reflect the issuance of a revised OMB Circular A-133.	October, 1996
Appendix H	Revised.	October, 1996

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